AVOIDING PITFALLS: EMPLOYER CONTRACTUAL AND COMPENSATION LESSONS FOR MODIFYING THE EMPLOYMENT RELATIONSHIP

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I. INTRODUCTION

During the summer of 2015, the Obama Administration proposed a Department of Labor rule to alter the employee overtime compensation eligibility criteria.[1] Specifically, the rule would allow more workers to receive overtime pay by raising the upper limit of covered compensation. The change proposed increasing the upper limit for required overtime pay from $23,660 to $47,476.[2] News of this impending change drew attention from employers and employees alike and spawned lawsuits to prevent the rule's implementation. The rule was first halted in 2016 by nation-wide injunction and then ultimately struck down in 2017 by U.S. District Judge Amos Mazzant of the Eastern District of Texas.[3]

Even though the Obama Administration's proposed rule will not go into effect, concern has not completely subsided among employers. Comments from the Trump Administration suggest that the upper limit will likely rise above the present level; even if it does not rise to the level of the proposed rule.[4] Employers, sensitive to labor cost increases which can add to their balance sheet, will not take this news lightly.[5]

Employers will likely look for ways to understand the impact of any change and how they can avoid or mitigate negative effects. One

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1. *Final Rule: Overtime*, U.S. DEP'T OF LAB., https://www.dol.gov/whd/overtime/final2016/ (last updated Jan. 2018).

2. *Id.*

3. Daniel Wiessner, *U.S. Judge Strikes Down Obama Administration Overtime Pay Rule*, REUTERS (Aug. 31, 2017, 4:20 PM), https://www.reuters.com/article/us-usa-overtime/u-s-judge-strikes-down-obama-administration-overtime-pay-rule-idUSKCN1BB2Y8.

4. Associated Press, *Trump's Labor Department Wants Salary Level to Determine Whether Workers Receive Overtime*, L.A. TIMES (Jun. 30, 2017, 10:50 AM), http://www.latimes.com/business/la-fi-overtime-salary-rule-20170630-story.html.

5. Alexia Elejalde-Ruiz & Jassen Kim, *Business Grapple with New Overtime Rule*, CHICAGO TRIBUNE (May 18, 2016, 5:53 PM), http://www.chicagotribune.com/business/ct-overtime-final-rule-0519-biz-20160518-story.html.

solution would be to lower the pay rate of affected employees.[6] Employers have several potential routes to reduce employees' pay rates. An employer may alter an employee's compensation calculation by increasing the base number of hours he is required to work in a given week.[7] This particular route presents noteworthy challenges.

This Article will examine how this change creates contractual and compensatory pitfalls for employers that seek to alter their employees' hours without properly understanding legal and procedural consequences. To fully appreciate these potential pitfalls, this Article will provide background on the employment-related structures that govern employee pay. The first background section, Part II, will discuss contract law concepts pertinent to the employment relationship. The second background section, Part III, will discuss the federal overtime compensation rule and the penalties associated with noncompliance.

Part IV of this Article will examine the contractual hurdles that employers must overcome to ensure a legally valid contract change and offer insight into the correct path to contract modification. Part V will then expose the potential errors associated with calculating the change in employee hourly rates and provide the correct calculation method that employers should follow. Finally, the Article will conclude with prescriptive remedies for employers to help them navigate this change.

II. BACKGROUND: CONTRACTUAL EMPLOYMENT RELATIONSHIP

In the majority of United States jurisdictions, the employment relationship presumes an "at-will" standard, which allows either party to "terminate" the relationship for any legal reason or no reason without facing legal liability.[8] Employers and employees can contract out of the "at-will" standard to require certain performance terms or conditions prior to termination.[9]

When the parties contract away from "at-will," the employment contract is the legal framework—consisting of an oral or written employment contract plus ancillary documents, such as the employee handbook[10]—that governs the relationship between employers and employees.[11] As a matter of contract, employers and employees are largely free to set the pertinent terms, so long as the terms do not

6. Duncan Adams, *New Overtime Rule for Salaried Workers Pushes Employers to Respond*, THE ROANOKE TIMES (Jul. 3, 2016), http://www.roanoke.com/business/news/new-overtime-rule-for-salaried-workers-pushes-employers-to-respond/article_fa49b444-8bb3-5808-a5d8-404de2a0eec8.html.

7. Suzanne Lucas, *Should an Employer Increase Employee Hours with No Extra Pay?*, THE BALANCE (last updated Mar. 01, 2018), https://www.thebalance.com/hour-increase-no-raise-1917854.

8. 27 AM. JUR. 2D *Employment Relationship* § 9 (2018).

9. *Id.*

10. *Id.* § 10.

11. *Id.* § 8.

violate federal or state statutes.[12] The employment agreement is finalized when the parties mutually agree to terms; signified, in most cases, by employees accepting employers' offer to work at the organization.[13] Acceptance binds the parties to the terms until the contract is satisfied or modified.[14]

After the employment agreement is established, employers face legal hurdles when seeking to alter an existing employees' contractual duties, such as increasing the required hours per workweek above a 40-hour workweek.[15] Under common law, and further supported in the Restatement (Second) of Contracts, an established legal duty owed by the parties to one another, known as a "pre-existing duty," generally may not be altered and enforced without additional consideration.[16]

To overcome the pre-existing duty rule, employers have a few options. Primarily, an employer can provide consideration to its employees for any change in the employees' obligations.[17] "Consideration" is a legal construct (requirement) necessary for an agreement's enforceability that requires a bargained-for exchange between the parties that motivates the promisor to act.[18] Under Section 71 of the Restatement (Second) of Contracts, consideration "is bargained-for if it is sought by the promisor in exchange for his promise and is given by the promisee in exchange for that promise."[19]

In the employment context, employers must give employees something they consider valuable in exchange for the increase in the hours worked.[20] In jurisdictions that require consideration beyond continued employment, employers could satisfy the consideration requirement by offering employees: one-time bonuses or increases in salary, additional responsibilities, or greater authority.[21]

III. BACKGROUND: OVERTIME COMPENSATION

Overtime compensation is governed both at the federal level by the Fair Labor Standards Act of 1938 ("FLSA")[22] and at the state level

12. *Id*. § 12; Christine Godsil Cooper, *The Basics of Employment Contracts*, GP SOLO LAW TRENDS & NEWS: LITIGATION (ABA), May 2007, https://www.americanbar.org/newsletter/publications/law_trends_news_practice_area_e_newsletter_home/0705_litigation_employmentcontracts.html.

13. 27 AM. JUR. 2D *Employment Relationship* § 8 (2018).

14. *Id*. § 21.

15. New employees are not at issue because the change can be implemented in the initial employment agreement and does not require the alteration of an existing agreement.

16. RESTATEMENT (SECOND) OF CONTRACTS § 73 (AM. LAW INST. 1981); K. A. Drechsler, Annotation, *Considerations for Change of Terms of Employment*, 158 A.L.R. 231 § 3(b) (1945).

17. Drechsler, *supra* note 16, at § 3(a).

18. *Consideration*, BLACK'S LAW DICTIONARY (10th ed. 2014).

19. RESTATEMENT (SECOND) OF CONTRACTS § 71 (AM. LAW INST. 1981).

20. 27 AM. JUR. 2D *Employment Relationship* § 13 (2018).

21. Drechsler, *supra* note 16, at § 4(b).

22. 29 U.S.C. § 207(g)(2) (2012).

by statute.[23] Under federal law, employers[24] are required to pay overtime when employees work beyond 40 hours in a workweek (seven consecutive 24-hour periods that need not follow a calendar week).[25] Overtime is calculated by multiplying the number of hours worked above the 40-hour threshold by "a rate not less than time and one-half their regular [hourly rate]" (1.5 times regular hourly rate).[26] For hourly, non-exempt[27] employees, overtime is simply the agreed upon hourly rate multiplied by time and one-half for each hour. For salaried, non-exempt employees, calculating overtime requires the extra step of first determining the regular hourly rate "by dividing the salary by the number of hours [for] which the salary is intended to compensate."[28] For example, hourly rates based on yearly salaries are divided by the number of hours that the employees are expected to work in a year, monthly salary by the hours expected in a month, and weekly salary by the hours in a week.

Employers that fail to comply with federal overtime laws expose themselves to potential liability from both the employees they incorrectly compensated and the federal government.[29] To rectify such failures, employers must pay "employees affected in the amount of . . . their unpaid overtime compensation, as the case may be, and an additional equal amount as liquated damages."[30] In plain terms, employers could have to pay employees twice the amount of unpaid back wages owed. Further, if employers violate federal overtime law, then they may also be assessed civil monetary penalties of up to $1,964 for each willful or repeated violation.[31]

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23. This Article will focus on the federal overtime compensation but can be extrapolated to the state level.

24. *Handy Reference Guide to the Fair Labor Standards Act*, U.S. DEP'T OF LAB., https://www.dol.gov/whd/regs/compliance/hrg.htm (last updated Sept. 2016).

25. *Fact Sheet # 23: Overtime Pay Requirement of the FLSA*, U.S. DEP'T OF LAB., https://www.dol.gov/whd/regs/compliance/whdfs23.pdf (last updated July 2008).

26. *Id.*; *see* 29 U.S.C. § 207(g)(2) (2012).

27. *Fact Sheet #17A: Exemption for Executive, Administrative, Professional Computer & Outside Sales Employees Under the Fair Labor Standards Act (FLSA)*, U.S. DEP'T OF LAB., https://www.dol.gov/whd/overtime/fs17a_overview.pdf (last updated July 2008).

28. 29 C.F.R. § 778.113(a) (2017).

29. *See generally Fact Sheet # 23: Overtime Pay Requirement of the FLSA*, U.S. DEP'T OF LAB., https://www.dol.gov/whd/regs/compliance/whdfs23.pdf (last updated July 2008) (noting that overtime pay is required by law).

30. 29 U.S.C. § 216(b) (2012).

31. *Id.* § 216(e)(2); *Compliance Assistance – Wages and the Fair Labor Standards Act (FLSA)*, U.S. Department of Labor, https://www.dol.gov/whd/flsa/index.htm#cmp (last visited Feb. 9, 2018); *General Information on the Fair Labor Standards Act (FLSA)*, U.S. DEP'T OF LAB., https://www.dol.gov/whd/regs/compliance/mwposter.htm (last updated July 2009).

IV. CONTRACTUAL PITFALLS

First, employers must understand the contractual pitfalls that could befall them when modifying employment agreements to increase the required hours per workweek. The potential contractual pitfalls will be demonstrated using the following scenario:

> Employer hires Employee to perform non-exempt tasks for the company. Employer and Employee enter into a written employment agreement that sets Employee's rate of pay at $500 per 40-hour workweek. Six months later, Employer informs Employee that he will now be expected to work a 45-hour workweek based on the same weekly salary (reducing the hourly pay rate). Employee works 45 hours, and Employer prepares a paycheck.

Error #1: Employer alters the employment agreement requiring Employee to work increased hours (40-hour workweek increased to a 45-hour workweek) but provides no consideration in return. Employee's increased hours expectation constitutes a change to the parties' legal obligation under the agreement as Employee must now perform additional work without receiving any added benefits.

As discussed above, employers need to provide some form of consideration in order for the change to be legally binding. Employers' failure to offer their employees anything in exchange for this new expectation violates the "pre-existing duty rule." The fact that employees work after being informed of the change does not ratify the change or make it legally binding. The continuation of work is considered performing in accordance with duties already owed and therefore, does not constitute consideration.

Error #2: Employer, knowing that he must offer Employee something in return for increasing the hours, gives Employee a token amount as consideration. Employer has attempted to correct the error made above by offering some level of consideration, but the modification still falls short of legal effectiveness.

Employers' token offers are deemed inadequate because the consideration is not a true "bargained for" exchange. Employees must receive something of value in order for the consideration to be effective.[32] So, how do employers determine whether the amount to be given is sufficient to qualify as adequate consideration?

Consideration is adequate when it "is fair and reasonable under the circumstances of the agreement."[33] Practically speaking, what constitutes "fair and reasonable" is dependent on the jurisdiction. In some states, the offer of continued employment in at at-will employment relationship would satisfy the new consideration

32. *See generally*, Frigon v. DBA Holdings, Inc., 787 A.2d 966, 969 (N.J. Super. 2002) (requiring serious and adequate consideration on behalf of the employee in negotiations with employers).

33. *Adequate Consideration*, BLACK'S LAW DICTIONARY (10th ed. 2014).

requirement.[34] Other states require that employees be given more than a guarantee of continued employment.[35]

Correct: Employer properly offers adequate consideration to Employee in exchange for the increase in hours.

Employers can ensure that they offer their employees meaningful consideration by performing the research necessary to be fully aware of its jurisdiction's consideration requirements. For guidance, employers can look to its jurisdiction's treatment of employment restrictive covenant modifications, a contractual change that have been widely examined by courts.[36]

V. COMPENSATION PITFALLS

Second, employers must also be aware of two compensation pitfalls that could cause them to violate federal overtime laws and the correct calculation method that would prevent them from doing so. To avoid the potential liabilities explained above, employers must navigate compensation pitfalls involving the miscalculation of employee overtime compensation. The issues involving miscalculation are best explained through demonstrative scenarios. The potential pitfalls will be based on the following scenario:

> Employer hires Employee to perform non-exempt tasks for the company. Employer and Employee enter into a written employment agreement that sets Employee's rate of pay at $400 per 45-hour workweek. In his fifth workweek, Employee works 45 hours, and Employer prepares a paycheck.

Error #1: Employer, unaware that he must adjust the compensation to reflect the overtime hours worked, pays Employee $400 based on the compensation arrangement stated in the employment agreement.

On its face, the compensation for hours worked is the exact bargain upon which the parties agreed. Unfortunately, this compensation scheme fails because employers are deemed to have paid all hours evenly rather than allocating extra compensation for the overtime hours. Employer from Error #1 violated federal overtime laws because the FLSA requires employers treat overtime hours differently than regular hours.[37]

Error #2: Employer, knowing that he must adjust the compensation to reflect the overtime hours worked, attempts to calculate the regular hourly rate but does so incorrectly. Employer knows that overtime hours are worth one and a half times a regular

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34. K. A. Drechsler, *Considerations for Change of Terms of Employment*, 158 A.L.R. 231, 253 §4(c)(1) (1945).

35. *Id.*

36. *See* Ferdinand S. Tinio, Annotation, *Sufficient of Consideration for Employee's Convent Not to Compete, Entered into after Inception of Employment*, 51 A.L.R.3d 825 (1973).

37. 29 C.F.R § 778.101 (2011).

hour and mistakenly accounts for that difference when calculating the hours worked. Employer divides the total by 47.5 hours (40 Regular Hours + (5 Overtime Hours x 1.5)).[38]

Using the increased hours figure, the regular hourly rate would equate to $8.42, and the overtime rate would equate to $12.63. For many employers, this might appear to be the right calculation method as it correctly tabulates the compensation requirements to reach the agreed upon workweek salary. Unfortunately, this logic runs counter to the intention of overtime compensation protection. Because both regular and overtime hours are used to calculate the regular hourly rate, any additional hours only depress the regular hourly rate and therefore, the employee never receives additional compensation beyond the $400 for additional hours worked.

Correct: Employer properly calculates Employee's compensation by dividing $400 by the agreed upon numbers of hours to be worked in during the workweek (45) to obtain the regular hourly rate.

The correct interpretation for the regular hourly rate calculation divides the total workweek salary by the number of agreed upon workweek hours.[39] Using this method, the correct regular hourly rate would equal $8.89 ($400/45 hours), and the overtime rate would equal $13.33. Employers calculating compensation in this manner will realize that the total compensation for the workweek exceeds $400 with the true workweek compensation equaling $422.25.

VI. CONCLUSION

As discussed in the analysis above, shifting required hours is not, in and of itself, a problem as long as employers take the proper steps to ensure that the employees receive their correct compensation. Employers should provide adequate consideration to employees in exchange for the increased hours worked and determine the new regular hourly rate using the correct calculation method. To accomplish this, employers should take note of several procedural steps that can keep them from stumbling into the above pitfalls:

First, employers should identify the pool of employees that are likely to be affected by a change in hours. Under the current upper limits for overtime compensation, employers should pay extra attention to changes involving existing salaried, non-exempt employees making less than the following amounts: $23,660.00 yearly, $1,971.66 monthly, or $455.00 weekly.[40]

Second, employers should identify the lower limit of compensation that it can legally provide to its employees. To

38. The calculation using the incorrect method appears as follows: Regular Hourly Rate = Total Workweek Salary ($) / (40 Regular Hours + (Number of Overtime Hours x 1.5)).

39. The calculation using the correct method appears as follows: Regular Hourly Rate = Total Workweek Salary / Number of Agreed Upon Workweek Hours.

40. 29 C.F.R. § 778.113(b) (2011); *Fact Sheet #17A, supra* note 27.

determine this threshold, employers must multiply the number of hours that employees are expected to work by the jurisdiction's minimum wage (minimum period salary = jurisdiction's minimum wage x # of expected hours in the period).[41] As a base, employers must keep salaries above the federal minimum wage of $7.25.[42] Thus, to meet federal minimums based on a 45-hour workweek, employers must pay: $16,965.00 yearly based on 2,340 hours, $1,413.75 monthly based on 195 hours, or $326.25 weekly. If employers operate in a state with a minimum wage above the federal minimum, then employers must also meet that compensation requirement when paying its employees. Combining each lower limit with its respective upper limit in the preceding paragraph establishes the relevant salary ranges for which employees must receive overtime compensation and the danger zone for when employee compensation becomes illegally low.

Third, employers should communicate any compensation changes directly to employees. As a practical matter, it is important for employers to discuss changes with their employees to ensure that no confusion exists between the parties.

The importance of properly handling contractual changes cannot be overstated. The potential financial harm and backlash that employers face from incorrectly altering their employees' pay rates could outpace potential cost-savings from reducing the amount of compensation paid. Because of this, employers should act cautiously and deliberately when making such changes.

41. *See generally* 29 U.S.C. § 206(a)(1)(C) (2012).
42. *Id.*