Transcript: Part One

Knowledge@Wharton: Compensation from an employee's view might be somewhat straightforward in terms of hours worked in overtime. When it comes to the distinction between exempt and nonexempt, I think things become a little foggier. So, Jim, could you start us off by giving us, from a legal perspective, what the difference is between exempt and nonexempt?

Matthews: Certainly. When we're talking about exempt or nonexempt, we're talking about the Federal Fair Labor Standards Act and the various state law analogs. And the question is whether a given employee is exempt from the overtime requirements of those statutes, which in terms of federal law means time and a half for all hours worked in excess of 40 in a work week. The presumption is that an employee is nonexempt unless the employer demonstrates that they fall within one of the specific classes of employees who are exempted by the statute and the implementing regulations.

Knowledge@Wharton: And Bernard, in terms of the workforce, what kinds of changes have been happening that are impacting how employers can deal with compensation along these lines?

Anderson: Well, there are mainly four major changes that have occurred in the economy that have affected the employment relationship and the management of compensation over the past four decades. The first I would point to is the transformation of the American economy from an industrial economy to a service-based and knowledge-based economy. The second, I would think, is the increased globalization, which places significant competitive pressures on domestic firms operating in an increasingly global environment.

The third is the emerging work and family relationship in the workplace. What we have seen over the past four decades is an increasing participation of women in the workforce, [an] increasing diversification of the workforce by a demographic group. And those changes place pressure on the ability of employers to manage the workplace in a way that allows workers to harmonize their work life and their family life.

And we also see increasing skill shortages in many occupational groups that place a premium on recruiting the right kind of employees, training them properly, developing them, retaining those who the employer wants to retain, and releasing those whom the employer would not like to retain.

In effect, what we have seen in the American workplace over the past four or five decades is a breakdown in the social compact that was entered into during the Great Depression and emerged and strengthened during the post World War II period. We now have a situation in which loyalty and job security have changed dramatically in the American workplace, and that is creating great challenges to employers in managing compensation.

Matthews: And then from the legal perspective -- if you sort of distill down what Bernard said -- is that there is increasing pressure on employers today to be flexible in the manner in which they manage their workplace: how, when, [and] under what circumstances they need their people to get their work done, [and] how they accommodate the other priorities that their employees have. Every employer would like to be as flexible as it can to maximize its own business success and accommodate to the extent it possibly can the desires of its employees. The problem is that the employer has to do that against the background of a

statute which is very inflexible, and which was designed, as Bernard said, for the industrial workplace of the 1930s, not for the virtual workplace of the 21st century.

We return to the question of exempt versus nonexempt. There are, as I said, very narrow classes of those who are exempt. The historic ones are executive, administrative, and professional employees. There have been some others added over time [like] outside sales people. There's a new category of computer professionals.

But if you go back and look at how those categories were developed, you have to look at it in the context of the industrial workplace of the 1930s where you truly had blue collar and white collar and everybody knew where the line was. The people who came in with their lunch pail and clocked in [each] morning and clocked out in the afternoon were hourly, nonexempt employees. The plant manager was an executive. The CFO or the office manager was an administrative employee: a staff [member] rather than a line employee who performed their service mostly for the organization rather than for its customers and who exercised independent judgment.

So you had the workers and the bosses, and you had the staff. And everybody knew who everybody else was, and it was a relatively straightforward analysis.… [T]he purpose of the statute -- remembering that this was developed during the Great Depression -- was not to create extra compensation for employees. It was intentionally to make it more expensive for an employer to work fewer employees longer hours so as to encourage the employer to hire more employees to work fewer hours, and therefore address the very serious unemployment that existed during the Great Depression.

So, very often when I'm dealing with a problem with a client, they'll say to me, "But that's crazy. That makes it more expensive for me to get my work done with an individual employee." And we'll say, "Well, that's absolutely right. That's exactly what the statute was intended to do." But it was intended to do it in 1938 when all you were talking about was wages, and where in the industrial workforce, basically, one hourly assembly line worker was fungible with another hourly worker. So, you worked Joe to 40 hours a week, and then Joe went home with his 40-hours pay, and Mary stepped up to the line and seamlessly took over whatever it was that Joe was doing for the hourly rate.

Anderson: And what has happened over time -- and the comment about the origin of … the Fair Labor Standards Act adopted in 1938 -- is that changes in technology [and] changes in the workplace have flipped that original purpose on its head. In 1938, the compensation that employees received was mainly the wages that they earned [on] an hourly basis. Today, compensation is more than just wages. Compensation includes benefits … health care, pensions, time off with pay, [and] other kinds of benefits which in fact make it more costly to hire a new employee rather than to work an existing employee overtime. That flips the whole purpose of the Fair Labor Standards Act on its head.

And it is also interesting that the regulations under which the statute is implemented have not changed in any significant way. The regulations were adopted in 1949. This was the first change that was made in them and revised to some extent in 1983. Only recently, in 2003, an effort was made to revise the regulations again -- the so called *541 Regulations* -- in order to bring them into the 21st century. That effort was not entirely successful.

But, what we have is a set of rules that are not entirely appropriate to the characteristics of the workplace today. The demographic characteristics of employees have changed. The way work is organized in the workplace has changed. We see more incentive compensation. We see more work organized in teams. We have very different systems for performance

evaluation, for developing workers on the job, and identifying those who are appropriate for promotion. All of those changes in the workplace have occurred with little or no change in the statute that regulates the employment relationship in the workplace.

Matthews: I think what we found in 2003 -- when the current Administration proposed changes to the regulations that were not really terribly dramatic in the overall scheme of things -- [was that] there were so many different constituencies who for one reason or another were comfortable. These were mostly employee constituencies who were comfortable with the existing status quo precisely because it … benefited them economically. [They] had come to enjoy the extra compensation … that the structure of the 1930s statute caused them to receive, even if it had nothing to do with the original purpose of the statute. They were of course quite hesitant to see any change in the regulations that might reduce that or eliminate it.

Given as polarized as we are politically in the country these days, people recall great rhetoric. [Some say] that this was actually an intentional effort by the Bush Administration to take money away from the American working person. I don't think anybody who has studied the issue believes that to be the case. But, that was the political rhetoric and shows how difficult it is to do what someone who is listening to this discussion would think ought to be done, which is: "Well, this is nuts. Let's take this 1938 statute and change it so that it makes sense today."

[That] sounds good in principle, but we saw what happened five years ago when very modest changes were proposed. It was a political firestorm. So, we are in a situation where it is really not likely to change. Even if we get a Democratic Administration and a Democratic Congress and they attempt some changes, I still don't see anything radical happening. So, what that means is that for the foreseeable future, unfortunately, employers are simply going to have to try to find a way to manage as best they can within the context of a statutory overtime framework that really doesn't make a lot of sense today.

Knowledge@Wharton: What are some of the ways that you see companies compensating for this incongruity between the statute and the realities of the business environment?

Anderson: Well, one of the ways some employers are attempting to reconcile that conflict is to outsource jobs. That is the importance of globalization.

See, at a time when the major goods and services that were produced in this country were distributed in this country, there was a lot of flexibility and a lot of leeway available to employers to raise prices if they wanted to maintain profits, and to operate in other ways that would allow them to increase prices in order to pay the higher wages and to accommodate higher cost of production. That is no longer the case.

In a global environment, domestic employers are competing with employers producing the same goods overseas and [who] then send those goods back to the U.S. for sale. The U.S. remains the largest market for the production of goods and services in the world today: a huge population, a high level of income, and all the rest. So outsourcing, which is a process that has been subject to a lot of criticism, is one of the products of the requirements of employees to compete in the current environment.

But then there are other practices that employers can adopt to help address the issues that we are discussing now. I label that: "Measures to the management of human resources that would produce a high performance workplace." There are certain techniques in managing the workforce, techniques that apply … to recruitment, to training, to the structure of

compensation systems, to retention planning, and also to turnover of the workforce that allows employers to gain a competitive advantage through the management of their human resources.

One company that I would point to that has mastered this new way of managing the workforce in a way that maximizes worker productivity is Southwest Airlines. It is very interesting that Southwest Airlines has a unionized workforce, the same as other airlines. Yet, the level of productivity of Southwest Airlines employees is higher than it is for any other airline operating in this country. Not only that, but their financial performance thus far has been much better. Since they first declared a quarterly profit, which they did five quarters after the company was established, they have had consistent profits in each quarter since that airline has been operating.

I think that other employers who are interested in ways of managing the workforce to maximize productivity and to minimize cost could well look at the kinds of practices that Southwest Airlines uses in order to be a very financially successful company.

Matthews: I think it is an interesting segue into specific Fair Labor Standards Act management issues to point out that one of the benefits that Southwest has in managing its workforce that way is that the Fair Labor Standards Act does not apply to airlines.

Airline employees [and] railroad employees, who are governed by the Federal Hours of Service Act or have FAA regulations that limit how long they can be on duty in a day, … are not governed by the Fair Labor Standards Act.… I was joking with a client about this after negotiating my first airline pilot contract. If you are a senior enough airline pilot, you can easily pack a month's work into the first 10 days of the month and then have the rest of the month off.

That is precisely the kind of flexibility that today's workforce is demanding, particularly younger people. [Those] who can stay up all night, like I cannot anymore, would just as soon work 80 hours this week and take next week off. In many industries [and] in many workplaces that would work because there is a discrete amount of work that has to be done by the end of next week. If it all gets done this week? Wonderful.

Computer programmers come to mind; [they] work like that. However, unless you are lucky with the way the work weeks fall, what would happen then was that you would have to pay a nonexempt employee -- who wanted to do that because they wanted to get their work done and go to the beach next week -- 40 hours straight time and 40 hours time and a half to do exactly the same work that they would do for 80 hours straight time as long as they spread it over two weeks.

And because -- again, going back to the workplace of the 1930s -- there is so much concern about employer abuse, there is no way for an employer and an employee to agree, even voluntarily, that: "Well OK fine, I understand I am entitled to time and a half, but if I can have next week off, I will work 80 hours this week of straight time." That agreement is unenforceable. The employer gets audited. You're going to have to pay the halftime time additionally. It's that simple.

So, that's a good example of the kind of flexibility that employers are often prevented from giving their employees simply by the fact that – again, going back to the industrial plant model of the 1930s -- every work week stands alone. The question is 40 hours in that work week. There are a few statutory or regulatory exceptions. Police and fire can be on what's called an eight and 80 plan, which means as long as you are paying time and a half after

eight [hours] in a day and you don't exceed 80 hours in a two week period, then you can cram the work into more than 40 hours in a week.

But, generally speaking, it's that sort of rigid structure and the inability essentially to negotiate even with a union. I mean, even if there is no imbalance of bargaining power because you are in the organized workplace, you can't even agree on a collective bargaining agreement with a union. "Well, OK, we will trade time and a half after 40 in a week for some other benefit we would rather have." You can't do it. It's unenforceable.

Anderson: Let's recognize that in the contemporary workplace, the overwhelming majority of workers work in the nonunion environment. Unions, which in the 1930s and 1940s represented about one-third or more of the private sector workforce, now represent in the private workforce less than 10% of all workers. That means that the overwhelming majority of American workplaces are nonunion.

Now, one of the downsides of that is that in the absence of the union, many employees have no voice. They don't have the ability to influence the terms and conditions of their employment. The employer then can exercise unilateral management determination. But, while the employer might have the opportunity to determine unilaterally the terms and conditions of employment, changes in the workforce mean that employees very often have other choices. They don't have to work for a particular employer.

Certainly in an environment of expanding employment -- which one would have except in the case of a slow economy like we have now or declining employment or increasing outsourcing of jobs -- employees have choices. They can work for this employer, or if they don't like the terms and conditions, they can go to work for another employer.

So, the employer has to find ways to accommodate the interests and needs of the workforce within the framework of the very rigid regulations under FLSA. But, even with that there is a good deal of flexibility that is possible through flex-time, flex-place arrangements, [or] other kinds of work scheduling arrangements that the employer can adopt on their own … and put in place if that seems to meet the needs of employees.

So, while it is far from a perfect solution, I think that employers would be well advised to work through very carefully the framework for the regulatory requirements in FLSA and find those points of deviation where flexible work scheduling is permissible within the framework of this current law.
