California Supreme Court Embraces Employee-Friendly Formula For Calculating OT Pay

Insights

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In a unanimous decision, the California Supreme Court today issued a ruling that will have far-reaching effects for employers who pay employees a flat rate bonus and overtime. Specifically, the court ruled that when calculating overtime in pay periods in which an employee earns a flat rate bonus, employers must divide the total compensation earned in a pay period by only the non-overtime hours worked by an employee.

This decision formally breaks from the federal manner of calculating overtime which allows for dividing total compensation by total hours worked to compute overtime pay. All California employers who pay such bonuses must now review their policies and pay practices to ensure compliance with this decision (*Alvarado v. Dart Container Corporation of California*).

Background: A Primer On Calculating The "Regular Rate" For Overtime
Beginning with the most basic premise, employees who perform work in excess of defined statutory limits are entitled to overtime pay under both federal and California law. Generally, both statutory schemes provide for pay at a rate of 1.5 times the "regular rate" earned by the employee.

Entire articles could be (and indeed have been) written on how to determine the regular rate itself. The regular rate calculation at issue in the *Alvarado* case involves how to compute the regular rate under California law when an employee is paid a flat sum bonus during a single pay period. The case implicates the federal scheme because the employer used a formula that was in compliance with the federal Fair Labor Standards Act (FLSA).

Under the FLSA, the regular rate includes all compensation, earnings, or "remuneration" for work performed, with specific payments excluded—such as reimbursed expenses, reporting-time premiums, vacation or holiday pay, or discretionary bonuses. Each of these exceptions have their own specific requirements and employers should consult with a labor and employment attorney for any questions on these exceptions. If an employee earns only an hourly wage, the regular rate likely would be the hourly wage.

However, if there are additional payments, the regular rate is calculated by dividing all earnings (excluding those payments mentioned above) by the total number of hours actually worked. This provides a fairly simple equation: all weekly earnings / all hours worked = regular Rate. Once

calculated, employees are then generally entitled to compensation at 1.5 times all hours worked in excess of 40 hours in a workweek. Oftentimes, employers will calculate overtime by first paying the regular hourly wage for all hours worked, including overtime, and then paying an overtime premium at one-half the regular rate for all overtime hours worked.

California generally follows the federal rules with a few exceptions and nuances. For example, overtime pay must be paid for all hours worked in excess of eight hours in any workday and 40 hours in any workweek, and on the first eight hours worked on the seventh consecutive day of work in any workweek. California also provides for double the regular rate for all hours worked in excess of 12 hours in any workday and for all hours worked in excess of eight on the seventh consecutive day of work in a workweek. Notably, the California Division of Labor Standards Enforcement (DLSE) Manual puts forth a formula which is not considered a formal regulation, but can be persuasive authority for California courts.

The *Alvarado v. Dart Container Corporation of California* Case

Hector Alvarado worked for Dart Container Corporation of California as a warehouse associate for approximately 16 months. Dart had a written policy providing for an attendance bonus for any employee who was scheduled to work a weekend shift and completed the full shift. The $15 per day bonus was paid regardless of the number of hours an employee worked beyond the normal scheduled length of a shift. In other words, whether the employee worked overtime or not, they received the bonus for completing a Saturday or Sunday shift.

Dart calculated overtime pay for attendance bonuses as follows:

*   Multiply the number of overtime hours worked in a pay period by the straight hourly rate (straight hourly pay for overtime hours).

*   Add the total amount owed in a pay period for (a) regular non-overtime work, (b) extra pay such as attendance bonuses, and (c) overtime due from the first step above. That total amount is divided by the total hours worked during the pay period. This amount is the employee's <u>regular rate</u>.

*   Multiply the number of overtime hours worked in a pay period by the employee's regular rate, which is determined in step 2. This amount is then divided in half to obtain the "overtime premium" amount, which is multiplied by the total number of overtime hours worked in the pay period (overtime premium pay).

*   Add the amount from step 1 to the amount in step 3 (total overtime pay). This overtime pay is added to the employee's regular hourly pay and the attendance bonus for the total compensation for the pay period.

During his employment, Alvarado earned attendance bonuses during weeks he worked overtime and sometimes double time.

In August 2012, Alvarado filed a lawsuit against Dart alleging that the company's formula for calculating overtime pay as outlined above did not comply with the law, among other related wage

calculating overtime pay as outlined above did not comply with the law, among other related wage and hour violations. Dart argued that its formula was lawful and that federal law should apply to calculating overtime on the bonuses because there was no California law providing a formula for calculating overtime on bonuses. The lower court ruled that Dart was in the right because its overtime formula complied with federal law and did not conflict with state law.

Alvarado argued his alternative formula was supported by a prior California Court of Appeal case and the DLSE Manual. The formula Alvarado advocated was as follows:

- Calculate the overtime compensation attributable only to an employee's hourly wages by multiplying the employee's hourly rate by 1.5 and by the number of overtime hours worked.

- Calculate the overtime premium attributable only to the employee's bonus by dividing the bonus amount by the total non-overtime hours worked and multiplying that value by 1.5.

- Multiply the bonus overtime premium by total overtime hours worked, and pay that amount in addition to the amount in step 1 as total overtime compensation.

The difference between Dart's formula and Alvarado's is that where Dart divides total compensation by total hours worked, the DLSE divides by only "regular hours," i.e., excluding overtime hours.

California Supreme Court Agrees With Worker, Adopts New Test
The issue for the California Supreme Court was, simply stated, what is the divisor (number to divide total compensation by) for purposes of calculating the per-hour value of a bonus. Specifically, should the divisor be (1) the number of hours the employee actually worked during the pay period, including overtime hours (the formula federal law allows and Dart used); (2) the number of non-overtime hours the employee worked during the pay period (the formula from the DLSE Manual and that Alvarado advanced); or (3) the number of non-overtime hours that exist in the pay period, regardless of the number of hours the employee actually worked (including hours such as vacation, sick pay, or similar time). While this all may seem like splitting hairs, the court determined that the formula put forth by Alvarado was "marginally more favorable to employees."

The court delved into the issues on appeal by first addressing whether the DLSE Manual is controlling, or whether it is a void "underground" regulation. The court determined that the DLSE Manual policy was void because it applied generally and implemented or interpreted the law enforced or administered by the DLSE, was not subject to formal rule-making procedures required by California administrative law, and was not a mere restatement of the law. But that's where the good news ended for employers.

Despite finding that the DLSE Manual was void, the court noted that the interpretation of state law contained within may be correct. While the Manual was not entitled to any special deference, the court determined that it may consider the agency's interpretation and the reasons for the DLSE's implementation if its own independent judgment reached the same conclusion. The court reasoned it may go so far as to "adopt the DLSE's interpretation as our own if we are persuaded that it is correct."

That is exactly what the court ultimately did. The court's guiding principles were two-fold: discouraging the imposition of overtime work through premium overtime pay, and interpreting state law liberally in favor of worker protection. With these principles in mind, the court reasoned that because the flat sum bonus at issue was payable even if the employee worked no overtime during the relevant pay period, it should be treated as being earned by only the non-overtime hours in the pay period. Accordingly, only non-overtime hours should be considered when calculating the bonuses' per-hour value.

In a final blow to employers, the court determined that its holding would <u>not only be given prospective application</u>, but would apply <u>retroactively</u>.

What This Means For Employers
First and foremost, you must review your policies and pay practices because the decision will apply retroactively, potentially subjecting you to penalties and liability based on past practices. This is especially important if you have operations in multiple states besides California and have centralized payroll operations that rely upon federal FLSA standards.

Also, the court expressly limited its decision to flat-sum bonuses as opposed to other kinds of non-hourly compensation, such as production bonuses, piece work, and commissions, in which a "different analysis may be warranted." However, the opinion could be used by employee advocates to raise meritless arguments that any non-hourly compensation is subject to the special rules for calculating overtime for flat sum bonuses outlined by the court. For these reasons, immediate compliance has now taken on added importance.

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