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Walking the Compensation Tightrope: OFCCP Issues Final Pay Equity Guidance

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Nineteen months to the day after initially publishing its guidance regarding Interpretive Standards for Systemic Compensation Discrimination under Executive Order 11246 (the "Standards"), 69 Fed. Reg. 67246 (Nov. 16, 2004), and Voluntary Guidelines for Self-Evaluation of Compensation Practices (the "Guidelines"), 69 Fed. Reg. 67252 (Nov. 16, 2004), the OFCCP issued the guidance in final form on June 16, 2006.

The Standards describe the methodology the agency will use in deciding whether to file an enforcement action against a contractor for systemic pay discrimination.¹ The Guidelines prescribe a voluntary self-evaluation methodology that will enable a contractor to avoid an OFCCP compensation investigation. The Guidelines also provide alternatives to the prescribed self-evaluation methodology, but if a contractor elects one of the alternatives the agency will proceed with its own investigation.

The Guidelines will be of more immediate concern to contractors than the Standards, as they are effective as of the date of publication, and arrive in a year when the OFCCP has unleashed a torrent of compliance evaluations (as many as three times the 2,500 to 3,000 evaluations conducted in 2005). Every contractor with a review pending, and those who receive scheduling letters in the future, will promptly have to make choices about how to undertake compensation self-analysis.

A number of changes were made to the proposed Guidelines as they were finalized; many are material and generally responsive to contractor concerns. The Guidelines must be read in the context of the Executive Order regulations that require compensation monitoring by contractors, 41 CFR 60-2.17(b)(3), and the standard desk audit information request ("Item 11") for summary compensation data by job title or other grouping of the contractor's choice. The Guidelines set forth a voluntary approach to compensation self-analysis that will satisfy the contractor's duty to self-monitor and that will relieve the contractor from producing compensation data during an evaluation. The methodology set forth in the Guidelines requires (1) analyzing Similarly Situated Employee Groupings ("SSEGs"), (2) using a

multiple regression analysis, and (3) factoring into the analysis the legitimate criteria that determine pay in the contractor's workplace. Contractors using the Guidelines' approach to self-evaluation will be required to provide substantial documentation to the agency, including information about remedial pay adjustments (which in the first year must include back pay and other make whole relief).

However, a contractor need not analyze its compensation in the fashion set forth. Two alternatives are outlined in the Guidelines:

- A contractor can certify in a writing, signed by a "duly authorized officer" under penalty of perjury, that it performed a statistical self analysis under the attorney-client privilege. In this case, the OFCCP will not require the contractor to disclose the analysis to the agency during a compliance evaluation, but it will evaluate the contractor's compensation practices using the agency's chosen methodology and without regard to the privileged self-evaluation; or
- A contractor can monitor its compensation practices with a non-statistical methodology, or a combination of statistical and other approaches, in order to comply with its regulatory requirement to monitor pay. The contractor will be required to turn over any such analysis or monitoring to the agency, but the contractor's efforts will not preclude the agency from doing its own study as well.

Which direction to take will require careful consideration. The best practice may be to conduct a non-privileged analysis to comply with the regulation's monitoring requirement, and to conduct a second, privileged analysis of troublesome or particularly complex issues, which need not be provided to the agency. Such a strategy should enable the contractor to avoid the certification requirement and the thorny issues it presents of maintaining the privileged nature of the studies.

Some of the other strategic decisions that contractors will need to confront include: What steps must be taken in order to conduct a compensation analysis under the attorney-client

privilege? Is the contractor prepared to accept the risk that a court some day may not uphold the privilege when disclosure of the analysis is sought in litigation with a third party? How can a contractor develop SSEGs? What data will be required to monitor pay decisions and practices? Should a contractor develop a consistent Item 11 strategy? What are the risks of sharing compensation analysis and remedial actions with the OFCCP?

In contrast to the Guidelines, the final enforcement Standards contain no material changes from the original proposals. The core features of the Standards remain:

- the agency will analyze the pay of employees who are “similarly situated;”
- the agency will use a multiple regression analysis to assess whether compensation differences are statistically significantly adverse to protected group members; and
- the agency will generally require anecdotal evidence to buttress the statistical findings before it will move to enforcement.

Over the year and a half the Standards and Guidelines have been pending, the OFCCP has implemented other, less burdensome investigative tools at the desk audit phase, which are briefly addressed in the final Standards.² It appears that the agency is going to continue to use these, and perhaps other-to-be-developed methodologies. Contractors need to understand these screening methodologies and, if possible, run them on their workforce data in anticipation of a compliance evaluation.

OFCCP’s Final Guidance Regarding Standards for Systemic Discrimination in Compensation and Guidelines for Contractor Self-Evaluation of Compensation Practices

Background

Until the proposed guidance was published, most OFCCP offices attempted to prove systemic pay discrimination under a disparate treatment, pattern or practice theory of discrimination. The agency used a pay analysis method that it never formally adopted, the so-called “Pay Grade Theory,” sometimes referred to as the “DuBray Method” or “median analysis” (collectively, “method”). Under that method, the OFCCP (i) assumed that employees in the same employer-assigned pay or salary grade or level were similarly situated for compensation-evaluation purposes, and (ii) compared the median compensation of males and females, and minorities and Caucasians, in each pay grade. If the OFCCP found a “significant” difference – a term never defined³ – in median compensation between males/females or minorities/non-minorities within a

given pay grade, it then looked to see whether the disparity was explained by median or average differences in other factors, such as time in grade, prior experience, education, or performance. Absent an explanation acceptable to the OFCCP, the agency issued either a Pre-Determination Notice or a Notice of Violation, asserting that the contractor had violated Executive Order 11246. Under the now final Standards, the OFCCP will no longer rely on the pay grade method because the method’s principal assumptions about pay grade or pay range do not comport with Title VII standards on whether employees are similarly situated, and the method resulted in grouping employees performing dissimilar work.

Guidelines for Contractor Voluntary Self-Evaluation of Compensation

Under the Guidelines, a contractor has two options. The contractor can conduct a compensation self-evaluation that “reasonably” implements the OFCCP’s prescribed methodology. If it does, it will be deemed in compliance with the requirement in 41 C.F.R. § 60-2.17(b)(3) to evaluate its compensation practices. Alternatively, the contractor can select its own form(s) of compensation monitoring, in which case the OFCCP will evaluate the contractor’s compensation practices itself.

The OFCCP-Prescribed Self-Evaluation Protocol

The OFCCP’s protocol for a compensation self-evaluation requires the following:

- The contractor’s self-evaluation must be performed on SSEGs. The contractor’s job titles and classifications, pay grades or ranges, and AAP job groupings are not dispositive on what constitutes an appropriate SSEG.
- The contractor must make a reasonable attempt to produce SSEGs that are large enough for meaningful statistical analysis (i.e., generally at least 30 employees overall, with five or more of both male and female and minority and non-minority incumbents.)
- The contractor may eliminate from the statistical evaluation employees who are not sufficiently similarly situated to other employees to permit them to be grouped in an SSEG, but must evaluate the pay of those employees using non-statistical methods.
- The contractor’s statistical analysis must include a significant majority (i.e., at least 70%) of the employees in the AAP or workplace.⁴ This is a decrease from the 80% requirement in the proposed Guidelines.
- The contractor must conduct an annual statistical analysis that accounts for the factors that legitimately affect the compensation of the members of the SSEGs under

the contractor's compensation system, such as experience, education, performance, productivity, location, or other factors.

- Only AAP establishments with 500 or more employees (up from 250 in the proposed Guidelines) must be analyzed using a regression analysis. The regression should not use factors that are tainted by discrimination, but a factor is not automatically disqualified merely because it correlates with a protected characteristic (e.g., race or gender) as long as the contractor has implemented formal standards to constrain subjective decision-making.
- Where a contractor finds a statistical disparity of two or more standard deviations from a zero disparity level, it must determine whether the disparity is explained by legitimate factors.
- If the pay differences cannot be explained by legitimate factors, the contractor must provide "appropriate remedies." The initial self-evaluation is expected to lead to adjustments to correct current differences and make-whole relief, including back pay, for differences over the prior two-years. In subsequent annual self-evaluations, the remedy would be limited to current differences. The final Guidelines skirt the issue of whether a remedy must reduce the pay difference to 0 standard deviations.

In addition, the contractor must contemporaneously create, retain, and make available to the OFCCP during a compliance evaluation:

- Documents necessary to explain and justify its decisions with respect to SSEGs, exclusion of employees from the regression, factors included in the statistical analysis, and the form of the statistical analysis;
- The data used in the statistical analysis and the results of the analysis for two years from the date they are performed;
- The data and documents explaining the results of the non-statistical methods that the contractor used to evaluate pay decisions regarding those employees not included in the statistical evaluation; and
- Documentation on any follow-up investigation (over the preceding two years) into statistically significant disparities, the conclusions of such investigations, and any pay adjustments made to remedy those disparities.

The OFCCP's Compliance Review of Compensation

If the contractor's self-evaluation comports with the above-described standards, the agency will deem the contractor's compensation practices to comply with Executive Order 11246. If the OFCCP concludes that the self-evaluation system is only

marginally reasonable under these guidelines, it may suggest in writing that the contractor make prospective modifications to the system. In such cases the OFCCP will assess during future compliance reviews whether the contractor made the suggested changes. If it has not, the OFCCP will no longer accept the contractor's self-evaluation system.

If the contractor selects its own form of analysis to comply with Section 60-2.17(b)(3)'s compensation-monitoring requirement, the OFCCP will audit the contractor's compensation de novo. If the contractor has performed, at the direction of counsel, a compensation self-evaluation of the AAP or workplace at issue, and counsel has advised the contractor that the analysis and results are subject to the attorney-client privilege and/or the attorney work product doctrine, and it does not want to turn over its methodology or results to the agency, it must make a written certification of its compliance with 41 CFR § 60-2.17(b)(3) in lieu of producing the methodology and results. That certification must be signed under penalty of perjury by a duly authorized officer of the contractor.

The OFCCP's Standard for Identifying Systemic Compensation Discrimination

The OFCCP's final Standards reiterate that Executive Order 11246 and the Department of Labor's Sex Discrimination Guidelines, 41 C.F.R. Part 60-20, prohibit systemic compensation discrimination, that is, dissimilar treatment of individuals who are similarly situated when that treatment results in adverse consequences for protected group members. The Standards contain extensive discussion of case law under Title VII that supports the agency's new approach.⁵

Similarly Situated Analysis Focuses On Facts

Determining who is similarly situated will focus on the nature of the work performed, the levels of responsibility, and the skills and qualifications required for the positions. In making this assessment, the OFCCP will rely on facts to be ascertained by considering job descriptions and interviewing employees. Pay grades, AAP job groups, and other preexisting groupings will be relevant only to the extent they in fact group employees with similar work, skills and qualifications, and responsibility levels. In the final Standards the agency noted that similarity in job duties, responsibility level, and skills/qualifications will not always mean that employees are similarly situated; it "will consider the applicability of additional factors [such as department assignment, divisions with different budgets, or levels of importance to the business] and make a determination based on the facts of the particular case."⁶

Multiple Regression Technique

The OFCCP will use multiple regression analysis to explore the impact of legitimate factors in explaining compensation differ-

ences. The agency proposes several specifications for regression analysis:

- The regression model must include those factors that are important in contractor pay decisions.
- Potential regression factors may include, but are not limited to, education, work experience with prior employers, seniority in the job, time in a particular salary grade, performance ratings, productivity, location, and job category or grouping of similarly situated incumbents.
- The regression should not use factors that are actually tainted by discrimination. How contractors will show that certain factors such as performance evaluations are not tainted remains to be seen.
- The Standards include many other detailed technical requirements for regressions, including that at least 80% of the employees in the establishment are covered in a regression.⁷
- Only disparities that are statistically significant, at a level of two or more standard deviations, can support a systemic discrimination finding.
- The Standards do not specify the percentage of employees who must be in statistically significant groups of similarly situated employees to support a finding of systemic discrimination. This was one of the most serious criticisms of the proposed Standards, and the final Standards do not address the issue.

Notices of Violation

Except in “unusual cases,” the OFCCP will not issue an NOV finding systemic compensation discrimination unless it has (i) anecdotal evidence, (ii) supplementing a statistically significant compensation disparity, (iii) that is based on a multiple regression analysis, (iv) that compares similarly situated employees and controls for factors that were used in making pay decisions.⁸ According to the Standards, the OFCCP will attach its regression analysis results and a summary of its anecdotal evidence to each NOV. Moreover, the final Standards add a promise that “OFCCP will provide the contractor with enough information about [its] regression model for the contractor to understand the basis for OFCCP’s determination and for the contractor to replicate [the] regression model.”

OFCCP Developments Since 2004: The Three-Pronged Test and The Cluster Analysis

Since 2004 the agency has developed a three-pronged screening test and a “cluster analysis”; neither was published for notice and comment. While the cluster analysis is mentioned briefly in the final Standards, the three-pronged test is not. Both are

conducted during the desk audit stage of a compliance evaluation, and both have been used as screening tests to determine whether to proceed with a pay equity investigation.

The three-pronged test screens a contractor’s Item 11 submission in order to determine whether or not the agency will request individualized compensation data. The Item 11 submission consists of average salary of employees grouped by grade, job title, job group or any other “pay division” of the contractor’s choice (SSEGs could be used if they have been developed). The agency first determines in which of the pay divisions the average pay of the protected group (women or minorities) is 2% or more less than the unprotected group, and also determines in which pay divisions the average pay of the protected group is 2% or more greater than the unprotected group. The agency then determines whether 30% or more of the protected group members in the AAP establishment are in pay divisions where the protected group is paid 2% or more less than the unprotected group. If it is fewer than 30% of the protected group members, the contractor “passes” the screening test and individualized compensation data will not be requested. If more than 30% of the protected group members are in adverse pay divisions, the agency moves on to the final prong of the screening test. That prong compares the percentage of protected group employees in adverse pay divisions with the percentage of unprotected group members in adverse pay divisions. If the ratio is less than 3:1 the contractor passes the test and no individualized data is requested. If the ratio is 3:1 or higher, the contractor fails the three-pronged test.

If the agency proceeds with a pay equity investigation beyond the Item 11 submission, it generally has requested the following 12 data points for all of the employees in the establishment:

- name or employee identification
- gender
- race/ethnicity
- date of birth
- job title
- grade or pay band
- time in company or date of hire
- time in job or grade, or date of last change in grade or title
- full or part time
- exempt/non-exempt
- location (if different than the establishment being evaluated)
- current salary

Based on these data points, the agency performs a cluster analysis, which creates comparison groups by relying on job titles. Where a job title meets the 30/5 criteria, it will be deemed a measurement group. Where job titles do not meet the criteria, groups of job titles will be “clustered” based on the average compensation of the jobs until the 30/5 size requirement is

met. The cluster model then uses the other factors as explanatory variables in a regression.

The agency has noted that it draws no conclusions about the presence of discrimination based on either the three-pronged test or the cluster analysis. However, contractors have been critical of the cluster analysis both because it is virtually impossible to replicate if the agency does not provide additional information about its grouping technique and because it groups employees without regard to whether they are “similarly situated,” a fundamental concept in the agency’s now-final Standards and Guidelines.⁹

The Time to Act is Now

The Guidelines present substantial new and immediate challenges to contractors. While some contractors have been preparing for the final guidance, many have not. The time for doing so is now, before the OFCCP is reviewing compensation practices at one of your establishments. There are risks and potential rewards in developing a comprehensive thoughtful strategy in this tricky area of discrimination law.

NOTES

¹Because the OFCCP relies on Title VII standards for determining compliance with the nondiscrimination requirements of Executive Order 11246, non-contractors as well as contractors will find portions of the final Standards instructive in assessing and defending claims of systemic pay discrimination.

²The agency has taken the position that publication is not required for either the three-pronged test of a contractor’s Item 11 submission or the “cluster” or “12-factor” analysis of individual employee data that many agency offices have been using.

³Different offices of the agency employed different “rules of thumb” in identifying a significant difference. Some used the \$1,000 difference rule, while others used a 2% difference test. There was never any clear rule on how many grades had to have such significant differences before the agency would find a pattern or practice of alleged compensation discrimination.

⁴The final Guidelines provide that a contractor may combine the employees at multiple establishments for purposes of creating SSEGs that are large enough to analyze. A self-analysis methodology cannot be done on a group smaller than an AAP establishment.

⁵In comments to the proposed Standards, contractors had expressed concerns that the agency would use the Standards in every compliance evaluation, thus imposing an enormous burden. The final Standards make clear that they will be used only if the agency determines that it may need to move for enforcement. As discussed below, the agency has developed other preliminary screening tests that it is using during the desk audit phase of a compliance evaluation to make a determination whether additional investigation of compensation is necessary.

⁶The agency responded to comments that it would be forced to group dissimilar employees to create groups of sufficient size for statistical analysis and to meet the agency’s desire to cover “most” of the employees in an establishment. The agency states that “[u]nder no circumstances will OFCCP attempt to combine, group, or compare employees who are not similarly situated under these final interpretive standards . . . regardless of statistical size requirement or of OFCCP’s general objective to include a significant majority of employees in the regression analysis.”

⁷The Standards continue to look to 80% coverage of an establishment’s work force. The Guidelines, however, have reduced the minimum coverage for a contractor’s self-analysis model to 70%.

⁸The final Standards clarify that the agency will allege a compensation discrimination violation if the contractor establishes significantly lower compensation rates for jobs (not for particular employees) that are occupied predominantly by women or minorities than for jobs occupied predominantly by men or non-minorities, where the evidence establishes that the contractor made the job wage-rate decisions based on the demographic characteristics of the incumbent employees that predominate in each job.

⁹The agency concedes in the final Standards that the “cluster analysis does not comport with Title VII standards for grouping similarly-situated employees, nor does the cluster regression include factors that were determined from an investigation of the employer’s pay practices.” Although the Standards deal the final death knell to the pay grade or median model, to some degree the cluster analysis breathes new life into it, because if job titles are grouped based on average compensation, it is likely that those jobs reside in the same grade in the contractor’s compensation system.

If you have any questions with respect to your affirmative action obligations generally or with respect to the new Standards and Guidelines, Paul Hastings has expertise to assist you.

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