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Avoiding Wage and Hour Traps In Any Economy

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As the Great Recession ebbs and companies begin to think about – gasp – hiring again, the mood among employers is one of cautious optimism. Although the nation continues to witness the highest rates of unemployment in more than a quarter century, better-than-expected gains in productivity, new home sales and rising stock prices are, at least, tentative cause for celebration.

But don't break out the Dom Perignon just yet. Wage and hour traps exist in every economy – *especially* those on the rebound. The very cost-savings measures that companies put in place to save their businesses during the recession (and the ongoing measures they are still using to stay afloat – frozen salaries, anyone?) may come back to haunt them in the end.

More and more, employers are relying on Reductions in Force ("RIF") alternatives to manage their labor costs. RIF alternatives appeal to companies, especially those that have already endured layoffs. While utilizing RIF alternatives may be motivated by good intentions and sound business judgment, they may also create serious legal risks to employers if implemented improperly. This article focuses on those risks and offers suggestions for executing RIF alternatives in a manner that will reduce exposure to wage and hour claims as employers embark on the long road to recovery.

Wage and Hour Law Primer

The Fair Labor Standards Act (FLSA), 29 U.S.C. §§ 201-262, establishes the federal minimum wage rate and guarantees that all non-exempt employees who work in excess of forty hours per week are entitled to receive overtime pay at a rate of one and one-half times their regular hourly rate. Employees who are properly classified as exempt – most commonly employees who qualify under the so-called "white collar" exemptions (i.e., administrative, executive, and professional employees) – are not entitled to overtime pay no matter how many hours they work. State wage and hour laws may impose additional burdens on employers, including higher minimum wage rates and prohibitions against certain types of deductions from employees' pay.[1]

The FLSA allows plaintiffs to bring their claims as "collective actions" by alleging that they are "similarly situated" to other employees. To join an FLSA collective action,

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employees must complete a consent-to-join or "opt-in" form and file it with the court. Under state law, however, participation in such lawsuits is automatic for all "similarly situated" employees whose legal claims arise from a common question of law or fact.[2] Thus, in a state law wage and hour "class" action, there is no "opt-in" requirement – if an employee does not wish to participate in the lawsuit, he or she must affirmatively exclude himself or herself from (or "opt out" of) the class.

In recent years, wage and hour litigation has increased dramatically.[3] News headlines proclaim a number of verdicts and settlements in the tens of millions of dollars and several in excess of $100 million.[4] The prevalence of these cases may be explained in part by the daunting nature of wage and hour law. There are literally dozens of exemptions to federal and state overtime requirements, which cover everything from amusement parks to wreathmakers,[5] but by far the most commonly litigated matters pertain to "white collar" exemptions. In order to qualify for one of the white collar exemptions, the employer must be able to show that the employee (1) meets the "duties test"; (2) meets the "salary basis test"; and (3) receives a minimum salary of $455.00 per week (or $23,660 per year).[6]

The Duties Test

The duties test, as applied to white collar exemptions, requires employers to show that their exempt employees fall into one of three categories: executive, administrative, or professional. Each exemption category has its own subset of requirements. To qualify for the executive exemption, the employee must (1) have "management" of at least a department or subdivision of the enterprise as his or her "primary duty"; (2) "customarily and regularly direct the work of two or more other employees"; and (3) possess "the authority to hire or fire other employees" or make "suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status of other employees" that are given "particular weight."[7] To qualify for the administrative exemption, the employee (1) must perform "office or non-manual work"; (2) have as his or her primary duty the performance of work that is "directly related to the management or general business operations of the employer or the employer's customers"; and (3) have as his or her primary duty work that includes the "exercise of discretion and independent judgment with respect to matters of significance."[8] The professional exemption breaks down into yet three more categories – learned professionals, creative professionals, and computer employees – each with its own requirements that the employer must satisfy to properly classify its employees as exempt.

The body of case law and administrative guidance devoted to the duties test is immense. Here, all one really needs to know is this: even if an employee falls neatly within one of the executive, administrative, or professional categories outlined above (which often is not the case), changes to that employee's compensation (i.e., salary reductions) could jeopardize his or her exempt status.

The Salary Basis Test

In addition to meeting the duties test and paying exempt employees at least the minimum weekly salary of $455.00, an employer must also pass the salary basis test.[9] To meet the salary basis test, exempt employees must receive their full salary

for any week in which they perform work, without regard to the number of days or hours worked.[10] There are many ways in which an employer may unwittingly violate the salary basis test. Generally, deductions taken from an exempt employee's salary in less than week-long increments (including deductions for partial-day absences[11] and full-day absences outside the employee's control[12]) may violate the salary basis requirements. For example, an employer should not make deductions for absences related to jury duty, court appearances, or temporary military leave because these are considered outside the employee's control.[13] Full-day absences occasioned by an employee's sickness, however, are deemed within the employee's control and may be deducted in accordance with a "bona fide" sick leave plan.[14]

Other RIF alternatives, such as furloughs and pay reductions, also pose significant salary basis issues for exempt employees. For example, if an employer shuts down its operations for a day and then pays its exempt employees only four-fifths of their salaries for the week, the pay reduction may destroy the employees' exempt status. Whereas non-exempt employees who work fewer hours can simply be paid for fewer hours worked, reducing the salaries of exempt employees because of lack of work will violate the salary basis test unless such reductions are made on a "permanent" basis in accordance with regulatory requirements.[15]

A violation of the salary basis test can result in massive amounts of unanticipated overtime liability. Even violations that occur through an employer's good intentions (as may result from RIF alternatives) may jeopardize the exempt status of *all* employees in the same job classification and require back payments of overtime compensation going back for a period of up to three years.[16] For this reason, it is extremely important that employers have a clearly communicated policy that (1) prohibits improper pay deductions and includes a complaint mechanism for all affected employees; (2) reimburses employees for any improper deductions as soon as the employer learns of the mistake; and (3) makes a good faith commitment to comply with such policies and avoid improper deductions in the future.

RIF Alternatives

When implemented properly, a RIF alternative option can be a useful tool for businesses operating in a recovery. It can help maintain operating costs without the long-term harmful consequences often associated with RIFs, such as loss of employee talent, low morale, and reduced productivity. When done haphazardly, however, utilizing a RIF alternative may lead to inadvertent violations of federal and state wage and hour laws, which may actually increase a company's labor expenses.

Furloughs

Mandatory days off or "furloughs" are common in many industries in which employers seek to reduce their operating costs, especially during slow times during the year. In difficult economic times, furloughs are a popular way to spread the pain across the entire workforce rather than targeting individual employees for layoff. In fact, employees sometimes request such cost-saving measures, and employers can gain popularity – occasionally even receiving positive press coverage – by implementing furlough programs to "save jobs." Because of the depth and length of the recession, however, employers are experimenting with more frequent furloughs,

longer furloughs, "floating" furloughs (where employees elect the day or days of their unpaid absence), and partial-week or partial-day furloughs that may last one or more days in a workweek or just a few hours during the workday. These types of creative furlough programs present special challenges for maintaining employees' exempt status.

A furlough that lasts for an entire workweek does not violate the salary basis test because exempt employees are only entitled to their weekly salaries for weeks in which they perform work. Since the employees perform no work during a full-week furlough, no salaries are due, no violation of the salary basis test occurs, and there is no threat to the employees' exempt classification. Yet, even weeklong furloughs may present wage and hour traps. First, exempt employees must not work at all during the furlough; if they perform any tasks, they will be entitled to an entire week's salary, which of course, would defeat the purpose of having the furlough. In an age where so many employees have Blackberries, laptops, and other remote access devices, enforcing an absolute ban on work may be difficult.[17] It is therefore important for employers to have a clear written policy prohibiting exempt employees from engaging in any company business during their furlough period and rigorously enforcing that policy.

Furloughs present a second challenge in determining whether to permit or mandate the use of accrued vacation leave or paid time off (PTO). Although voluntary and mandatory use of vacation time or PTO is permissible during a furlough, deductions for vacation or PTO pay may jeopardize their exempt status.

Unused Vacation. Federal and state wage and hour laws do not require employers to provide employees with any vacation time at all. However, most employers do provide some form of vacation or PTO, and approximately half the states in the nation require that accrued, unused vacation time be paid out upon termination.[18] Even when a state permits deductions for unused vacation or PTO, partial-day deductions from an employee's bank of vacation, personal leave, or other PTO may still jeopardize the employee's exempt status.

Borrowed Vacation. Deductions from an employee's wages to repay borrowed vacation may also be prohibited under some state wage and hour laws.[19] Before deducting for borrowed vacation time (or for tuition reimbursement or other advances in pay), employers should consider whether the state or states in which they operate treat such benefits as wages, and then consider whether such debts may be collected upon termination.

Forced Vacation. Rather than deduct for vacation time upon termination, some employers force employees to use their accrued vacation time during furloughs or temporary plant shutdowns.[20] The U.S. Department of Labor (DOL) addressed this issue in a recent opinion letter and found that not only was it permissible to force employees to use vacation during such periods, but also it would not jeopardize the salary basis test for exempt employees. In reaching this conclusion, the DOL reasoned that "[because] employers are not required under the FLSA to provide any vacation time to employees, there is no prohibition on an employer giving vacation time and later requiring that such vacation time be taken on specific days."[21] Forced vacation in partial-day increments, however, may still violate the salary basis test.

Hence, if an exempt employee takes time off in the morning for a doctor's appointment or other personal reason, the employer should allow the employee to return to work or should pay the employee for the full day to avoid any possible violation.

Some state statutes, collective bargaining agreements, and company policies may require employers to provide advance notice of a furlough. Furloughs that extend for long periods of time may also trigger the federal Worker Adjustment and Retraining Notification Act (WARN)[22] and analogous state laws. Failure to provide the required advance notice in such circumstances could result in civil fines, back pay arbitration awards, or common law claims.

Reductions in Salary

To avoid layoffs (or at least to minimize their scope), some employers have initiated widespread reductions in salary. Salary reductions can be an effective tool for retaining a company's top performers, while at the same time providing incentives for others in the organization to improve their performance. However, they can also compromise the salary basis test when an employer makes frequent changes to exempt employees' base salaries to account for variations in scheduled working hours.[23] If an employer makes these adjustments with such frequency that the arrangement appears designed to circumvent paying employees overtime, the employer may lose the benefit of an otherwise applicable exemption.[24] Courts commonly refer to such a pay practice as a "sham."[25]

The regulations include no guidance as to the frequency of changes necessary to make an employee's salary a "sham," and until recently, the case law was also silent on this issue. Then, in 2005, the Tenth Circuit decided *In re Wal-Mart Stores, Inc.* (*Archuleta I*),[26] a case involving retail pharmacists who worked at Wal-Mart and had seasonal adjustments made to their working hours and salaries. Although *Archuleta I* did not directly address Wal-Mart's pay practice, the Court did provide an extreme example of a pay practice "sham," citing a trial court case in which firefighters worked in a rotation that resulted in changes to their scheduled hours and salaries in each and every pay period.[27]

In 2008, two appellate decisions provided more concrete guidance about what frequency in salary adjustments will jeopardize the salary basis test. The Tenth Circuit's decision in *Archuleta v. Wal-Mart Stores, Inc.* (*Archuleta II*)[28] examined the claims of several groups of pharmacists whose salaries were periodically adjusted. Pharmacists in the first group experienced two changes in their schedules and salaries, with an average period of time between changes of more than 11.3 months;[29] the second group experienced three changes, averaging 10.3 months between changes;[30] and finally, the third group experienced four changes, averaging 7.8 months between changes.[31] The Court held that the frequency of changes for all of these individuals was insufficient as a matter of law to compromise the salary basis test.[32]

The *Archuleta II* Court also examined two pharmacists whom it found potentially able to state a claim for overtime compensation. One of those individuals experienced alterations in his scheduled working hours and pay in seventeen of twenty-one pay

periods (or approximately 81 percent of the pay periods) spanning a period of nine months.[33] The other individual was paid a reduced salary for five pay periods over an unstated period of time as a result of the employee's agreement to take two full days off during those pay periods.[34] The Court held that these two individuals had established a triable issue of fact as to whether the employer had adjusted their working hours and salaries in an effort to circumvent the salary basis test.[35]

The Second Circuit's decision in *Havey v. Homebound Mortgage*, Inc.,[36] provides further guidance regarding the circumstances in which an employer may prospectively adjust exempt employees' salaries. *Havey* involved mortgage underwriters, who received base salaries that corresponded to the number of loans they had closed in the preceding quarter.[37] To the extent that an underwriter's productivity fell below his or her productivity target in a quarter, the employee's base salary would be prospectively reduced for the following quarter.[38] The Court affirmed summary judgment dismissing the case against the employer, reasoning that the quarterly adjustments did not allow for an inference that they were "designed for the purpose of circumventing the requirements of FLSA."[39]

The DOL has also confirmed that the salary basis test allows for occasional prospective reductions in salary or hours.[40] In 1998, the DOL opined that "a fixed reduction in salary effective during a period when a company operates a shortened workweek due to economic conditions would be a bona fide reduction *not* designed to circumvent the salary basis payment."[41] More recently, however, the DOL has drawn a distinction between deductions based on "short-term business needs" that are made on a day-to-day or week-to-week basis and *bona fide* reductions in salary that are not designed to circumvent the salary basis test.[42]

Based on these authorities, it appears that employers can avoid compromising employees' exempt status by implementing reductions in salary and hours prospectively for a period of at least three months, on a quarterly or semi-annual basis. Reductions that are made more frequently than that are more likely to fail the salary basis test and those made retroactively should be avoided altogether.[43]

Deductions from Final Paychecks

Deducting money from an employee's final paycheck is a common wage and hour trap. Penalties for improper deductions vary from state to state, and some jurisdictions allow for multiple damages.[44] Improper final pay deductions may also violate the salary basis test. Employers should consult with legal counsel to learn what deductions are permissible in a given jurisdiction before engaging in the practice.

Conclusion

When a RIF alternative is found to have violated a wage and hour law, the effects can be financially disastrous to the employer. Rather than achieving the intended cost savings, the result may lead to costly litigation for overtime pay brought on behalf of many or all of the company's affected employees. In this period of a nascent recovery, employers cannot assume the risk of such exposure. With the incidence of class and collective actions continuing to swell, the threat of a lawsuit

resulting from a poorly designed RIF alternative is real. For this reason, employers are wise to consider their options carefully, obtain sound advice from their experienced employment counsel, and develop a prudent plan to meet their business needs.

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[1] For example, unlike the FLSA, California wage and hour law calculates overtime pay by day rather than week, so that a non-exempt employee who works in excess of eight hours per day is entitled to overtime pay regardless of his or her total hours for the week. Cal. Lab. Code § 510. Massachusetts also deviates from the FLSA by prohibiting employers from deducting for accrued but unused vacation time. *See "An Advisory from the Attorney General's Fair Labor Division on Vacation Policies"* (Advisory 1999/1), http://www.mass.gov/?pageID=cagoterminal&L=3&L0=Home&L1=Workplace+Rights&L2=Wage+and+Hour&sid=Cago&b=terminalcontent&f=workplace_vacation&csid=Cago.

[2] State law wage and hour class actions are governed by Rule 23 of the Federal Rules of Civil Procedure.

[3] Administrative Office of the U.S. Courts, *Federal Judicial Caseload Statistics* (2000–2008). In 2007, the number of FLSA lawsuits filed in federal district courts increased by nearly 50 percent over the previous year. *Id.* Based on data collected and maintained by Seyfarth Shaw LLP, the number of wage and hour lawsuits filed in federal courts on an annual basis from 2000 to 2009 more than tripled.

[4] *See*, *e.g.*, *Wal-Mart Pays up to $640M to Settle Years of Worker Suits*, USA Today, Dec. 24, 2008 (*In re Wal-Mart Wage & Hour Employment Practices Litig.*, Case No. MDL 1735 (D. Nev.) and various other courts); *Starbucks Ordered To Pay $105M in Tip-Sharing Suit*, The Boston Globe, Mar. 22, 2008 (citing *Chau v. Starbucks Corp.*, No. GIC836925 (Cal. Super. Ct. Mar. 19, 2008), *rev'd*, 174 Cal. App. 4th 688 (2009); *IBM Agrees to Pay $65 Million to Settle Overtime Claims Involving IT Workers*, Class Action Litigation Report (BNA), at 827 (Dec. 8, 2006).

[5] *E.g.*, the seasonal amusement or recreational establishment exemption, 29 U.S.C. § 213(a)(3); the agricultural exemptions, 29 U.S.C. § 213(a)(6) and §§ 213(b)(12)-(13); the small newspaper exemption, 29 U.S.C. § 213(a)(8); the domestic companion exemption, 29 U.S.C. § 213(a)(15); the railway and air carrier exemptions, 29 U.S.C. §§ 213(b)(2)-(3); the seaman exemption, 29 U.S.C. § 213(b)(6); the taxicab exemption, 29 U.S.C. § 213(b)(17);

the domestic service exemption, 29 U.S.C. § 213(b)(21); the motion picture theater exemption, 29 U.S.C. § 213(b)(27); and the exemption for the delivery of newspapers and wreathmaking, 29 U.S.C. § 213(d); 29 C.F.R. § 780.1016.

[6] 29 C.F.R. § 541.600 (requirements (2) and (3) do not apply to outside sales employees, teachers, certain computer professionals, or employees practicing law or medicine). Employers may pay an exempt employee additional compensation over and above the "predetermined amount," without jeopardizing the employee's exempt status. This is true even if that additional compensation is paid at an hourly rate for each hour worked beyond the employee's regular schedule. DOL Wage & Hour Op. Ltr. FLSA1995-1738 (Apr. 6, 1995); *ACS v. Detroit Edison Co.*, 444 F.3d 763, 768 (6th Cir. 2006); *Kennedy v. Commonwealth Edison Co.*, 410 F.3d 365, 370-371 (7th Cir. 2005); *Fife v. Harmon*, 171 F.3d 1173 (8th Cir. 1999).

[7] 29 C.F.R. § 541.100(a)(1)-(4).

[8] 29 C.F.R. § 541.200(a).

[9] 29 C.F.R. § 541.200.

[10] As with so many areas of wage and hour law, there are certain limited exceptions to the salary basis test for deductions made in full-day increments for full-day absences. 29 C.F.R. § 541.602(b).

[11] There are two very narrow exceptions to the general rule that partial-day deductions violate the salary basis test. First, partial-day deductions may be made to penalize exempt employees who violate safety rules of major significance. 29 C.F.R. § 541.602(b)(4). Second, partial-day deductions may be made for intermittent or reduced leave under the Family and Medical Leave Act (FMLA). 29 C.F.R. § 541.602(b)(7). Despite these exceptions, partial-day deductions for exempt employees will violate the salary basis test more often than not.

[12] 29 C.F.R. § 541.118(a)(4).

[13] *Id.*

[14] The DOL has determined that a sick leave plan is "bona fide" if (1) there are defined sick leave benefits; (2) the benefits have been communicated to eligible employees; (3) the plan operates as described; (4) it is administered impartially; and (5) its design does not reflect an effort to evade the requirements that exempt employees be paid on a salary basis. DOL Wage & Hour Op. Ltr. FLSA2006-32, at 2–3 (Sept. 14, 2006).

[15] 29 C.F.R. § 541.602(a).

[16] The statute of limitations varies from two to six years under state law; however, most states allow misclassified employees to receive back overtime pay for up to two or three years.

[17] We do not imply that the "*de minimis*" use of such devices is compensable work. Such a discussion is beyond the scope of this article.

[18] CCH Smart Chart, *Vacation Pay Upon Termination*, http://hr.cch.com/smartcharts/template1.aspx?product=SELCA&DI=0a3f84ac71bc2dadcbadcfd5c658e948&U=dfleming%40seyfarth.com&IBUMSWB=B015AC79C31D42C589A7649C96363820&IBUMSID=474124 (last visited Oct. 16, 2009).

[19] California Department of Industrial Relations, Division of Labor Standards Enforcement, http://www.dir.ca.gov/dlse/FAQ_vacation.htm.

[20] DOL Wage & Hour Op. Ltr. FLSA2009-2 (Jan. 14, 2009).

[21] *Id.* (quoting DOL Wage & Hour Op. Ltr. FLSA2005-41 (Oct. 24, 2005)).

[22] 29 U.S.C. 2101 *et seq.*

[23] *In re Wal-Mart Stores, Inc.*, 395 F.3d 1177, 1188-99 (10th Cir. 2005) (*Archuleta I*) (citing *Thomas v. County of Fairfax, Virgina*, 758 F. Supp. 353 (E.D. Va. 1991)).

[24] *Havey v. Homebound Mortgage, Inc.*, 547 F.3d 158, 166 (2d Cir. 2008) ("Where the practice of prospectively changing salaries occurs so as to render the salary a 'sham – the functional equivalent of hourly wages,' . . . it would offend the 'salary-basis test.'") (quoting *Archuleta I*, 395 F.3d at 1179); *Archuleta v. Wal-Mart Stores, Inc.*, 543 F.3d 1226, 1231 (10th Cir. 2008) (*Archuleta II*) (same).

[25] *See, e.g., Archuleta I*, 395 F.3d at 1188-89 (holding that where employees' scheduled working hours and rate of pay are adjusted every pay period or nearly every pay period (81 percent of pay periods during nine-month period), employer's practices will likely be deemed a "sham") (internal citation omitted); *but cf. Havey*, 547 F.3d at 165-66 (holding pay practice

that prospectively adjusts employee's salary four times per year does not pose substantial risk that employer's practices will be deemed a "sham").

[26] *Archuleta I*, 395 F.3d 1177.

[27] *Id.* at 1188-89 (citing *Thomas*, 758 F. Supp. 353).

[28] *Archuleta II*, 543 F.3d 1226.

[29] *Id.* at 1233.

[30] *Id.*

[31] *Id.* at 1234.

[32] *Id.*

[33] *Id.* at 1236.

[34] *Id.*

[35] *Id.* It could be argued that the second employee's salary basis test claim derived from impermissible deductions from his stated salary, rather than from the employer's changing his salary so frequently that the practice created a "sham." The *Archuleta II* decision does not provide an analysis of this issue.

[36] *Havey*, 547 F.3d 158.

[37] *Id.* at 161.

[38] *Id.*

[39] *Id.* at 166.

[40] DOL Wage & Hour Op. Ltr. FLSA1998 (Feb. 23, 1998); DOL Wage & Hour Op. Ltr. FLSA1997 (Mar. 4, 1997); DOL Wage & Hour Op. Ltr. FLSA1970 (Nov. 13, 1970).

[41] DOL Wage & Hour Op. Ltr. FLSA1998 (Feb. 23, 1998) (emphasis in original).

[42] DOL Wage & Hour Op. Ltr. FLSA2009-14 (Jan. 15, 2009).

[43] *See* note 12 *supra*.

[44] *See, e.g.*, Cal. Lab. Code § 206; Mass. Gen. Laws ch. 149, § 150 (mandating treble damages for all violations of the Massachusetts Wage Act) (effective July 12, 2008).