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Exemption under the Fair Labor Standards Act

The Cost of Misclassifying Employees

Many employers have run afoul of the federal law that distinguishes hourly employees—who must be paid for overtime hours—from those who may be paid a fixed salary without regard to the number of hours worked.

BY JEFFREY D. POLLACK

As an employer, you undoubtedly know that the Fair Labor Standards Act (FLSA) requires an employer to pay an employee overtime after 40 hours of work per week.[1] You also know that the FLSA contains certain overtime exemptions, including what some refer to as the "white-collar exemption." The FLSA, however, does not actually contain a white-collar exemption as such. Rather, the statute exempts persons "employed in a *bona fide* executive, administrative, or professional capacity."[2]

Failure to pay proper overtime can result in liability for the unpaid overtime and an equal amount in liquidated damages (plus attorneys' fees). Given that possible outcome, misclassification of employees is a growing area for class-action litigation. Significantly, the statute also imposes personal liability on "any person acting directly or indirectly in the interest of an employer in relation to an employee."[3]

[1] Certain states (e.g., California) have additional overtime requirements. This article addresses only the federal law, under which overtime must equal at least one-and-one-half times the employee's "regular rate." (For a discussion of what constitutes an employee's "regular rate" see: "Overtime: Determining an Employee's Regular Rate," *New York Law Journal*, November 21, 2000, p. A1.) Contrary to common belief, private employers may not grant compensatory time off in lieu of overtime pay, but such an allowance has at least been proposed in Congress.

[2] The exemption also includes computer programmers and "any employee employed in the capacity of academic administrative personnel or teacher in elementary or secondary schools, or in the capacity of outside salesman." For example, see: 29 U.S.C. § 213(a).

[3] 29 U.S.C. § 203(d).

Understanding exemptions. Understanding the administrative and executive exemptions to the wage-and-hour laws, therefore, is crucial for proper human-resources management. This article will explain the executive and administrative exemptions, and then examine the remedies available to misclassified employees.

Dual tests. Before an employee will be deemed employed in a *bona fide* executive or administrative capacity, the employer must establish that the employee meets both a salary test and a duties test.

The Salary Test

The salary test is identical regardless of whether the employer claims an executive exemption or administrative exemption. In essence, the employer must remit a constant paycheck to the employee. As the statute puts it, the employee must "regularly receive each pay period, on a weekly or less frequent basis, a predetermined amount [at least $250 per week] constituting all or part of his compensation, which amount is not subject to reduction because of variations in the quality or quantity of work performed."[4] Although the employer need not pay for any week in which the employee performs no work, subject to certain exceptions, the employee must receive his full salary for any week in which he performs any work—regardless of the number of days or hours worked.[5] The employer may not reduce the compensation for absences occasioned by the employer or operation of the business itself (e.g., lack of work).

For absences of less than a week caused by jury duty, attendance as a witness, or temporary military leave, employers may offset any amount the employee receives as jury or witness fees or military pay for a particular week against the salary due for that week.

Whole days. Deductions of a day or more (but less than a week) are permitted only for absences resulting from:

(1) personal reasons other than sickness or accident;
(2) "sickness or disability (including industrial accidents), [but only] in accordance with a *bona fide* plan, policy, or practice of providing compensation for loss of salary occasioned by both sickness and disability"; or
(3) good-faith discipline for "infractions of safety rules of major significance."[6]

The statute makes a careful distinction regarding work days missed for personal reasons versus fractions of a day (or hours). Employers may "dock a salaried employee when the employee misses a day of work for personal reasons, [but he or she] may not be docked pay for fractions of a day of work missed. Accordingly, if an employee can be docked for fractions of a workday missed, then that employee is an hourly, not a salaried, employee."[7]

There is, however, one exception to this rule. In cases of intermittent leave pursuant to the Family and Medical Leave Act (FMLA), employers may deduct for periods of absence that equal less than a day.[8] Additionally, several courts and the Department of Labor take the position that non-FMLA absences of less than a day may be charged against an employee's accrued leave time.[9]

Understanding these rules is critical, because the U.S. Supreme Court has held that an employer with "either an actual practice of making [improper] deductions or an employment policy that creates a 'significant likelihood' of such deductions" forfeits the exemption.[10] According to the Court, this analysis:

[4] 29 C.F.R. § 541.118(a). The duties tests discussed herein apply only to employees earning at least $250 per week. Those earning between $155 and $250 per week must meet additional requirements. See: 29 C.F.R. § 541.1-.3 (setting forth additional tests for those making less than $250). The minimum salary amounts have not been revised since 1981. For example, see: 29 C.F.R. § 541.1(f).

[5] *Ibid.* An exempt employee need not receive a full week's pay in her initial or terminal weeks of employment. 29 C.F.R. § 541.118(c).

[6] Safety rules of major significance are limited to those designed to prevent serious danger to the plant or other employees. 29 C.F.R. § 541.118(a)(5).

[7] *Whitmore v. The Port Authority of New York & New Jersey*, 907 F.2d 20, 21 (2d Cir. 1990).

[8] See: 29 C.F.R. § 541.118. Only leave time actually taken under the FMLA may be deducted in hour increments. Deductions may not be made for employees who do not qualify for FMLA leave. See: 29 C.F.R. § 825.206.

[9] Compare: *Graziano v. Society of the N.Y. Hosp.*, 1997 U.S. Dist. Lexis 15926 (S.D.N.Y. October 15, 1997), which states that such deductions do not destroy exempt status, and Department of Labor Opinion Letter dated July 23, 1997, reprinted in 6A Wage and Hour Manual (BNA) 99:8090 (same), *with Service Employees Int'l Union Local 102 v. County of San Diego*, 784 F. Supp. 1503 (S.D. CA 1992), stating that deductions negate salary status.

[10] *Auer v. Robbins*, 519 U.S. 452, 461, 117 S. Ct. 905, 911 (1997).

> [R]ejects a wooden requirement of actual deductions, but...requires a "clear and particularized" policy—one which effectively communicates that deductions will be made in specified circumstances. This avoids the imposition of massive and unanticipated liquidated damages in situations in which a vague or broadly worded policy is nominally applicable to a whole range of personnel but is not significantly likely to be invoked against salaried employees.[11]

The Court distinguished between policies directed at specific employees, in this case police officers, and those directed at employees in general. Only a policy directed specifically at the employees in question can effectively communicate a possibility of deductions.

> The policy on which petitioners rely is contained in a section of the Police Manual that lists a total of 58 possible rule violations and specifies the range of penalties associated with each. All department employees are nominally covered by the manual, and some of the specified penalties involve disciplinary deductions in pay. [T]hat is not enough to render petitioners' pay "subject to" disciplinary deductions within the meaning of the salary basis test. This is so because the manual does not "effectively communicate" that pay deductions are an anticipated form of punishment for employees in petitioners' category, since it is perfectly possible to give full effect to every aspect of the manual without drawing any inference of that sort. If the statement of available penalties applied solely to petitioners, matters would be different; *but since it applies both to petitioners and to employees who are unquestionably not paid on a salary basis, the expressed availability of disciplinary deductions may have reference only to the latter.* No clear inference can be drawn as to the likelihood of a sanction's being applied to employees such as petitioners. Nor... is such a likelihood established by the one time deduction in a sergeant's pay, under unusual circumstances [emphasis added].[12]

The Court also stated that a single improper deduction does not establish an actual policy of deductions or a significant likelihood thereof.

Illustrative Cases

Hoffman v. Sbarro, Inc., was a class action brought on behalf of current and former managers of Sbarro restaurants, challenging the chain's policy of requiring managers to reimburse cash and inventory shortages or other losses occurring under their watch.[13] To enforce this policy, Sbarro required all managers to sign a form called "Agreement to Reimburse Losses," which authorized Sbarro to deduct any loss or shortage from the employee's wages or, alternatively, required the managers to repay losses out of their own pockets. Plaintiffs alleged that this policy rendered their compensation "subject to reduction because of variations in the quality or quantity of work performed." The court denied Sbarro's motion to dismiss this action, finding that plaintiffs sufficiently alleged, among other things, that Sbarro had an actual practice of reducing managers' pay and that managers were "actually and as a practical matter subject to" reductions in wages.[14]

Current and former managers and assistant managers of some Shoney's restaurants made a similar claim in *Belchers v. Shoney's, Inc.*[15] Among the evidence on which the court relied in granting plaintiffs' motion for summary judgment were several memos from top-level corporate executives explaining the salary-deduction policy, a reference to the policy in the "Manager's Reference Manual," and the existence and use of a corporate-wide "Payroll Deduction Authorization Casualty Loss Reimbursement" form. Taken together, these established an employment policy that created a significant likelihood of improper

[11] *Auer*, 519 U.S. at 461.

[12] *Ibid.* Compare to: *Cowan v. Treetop Enterprises, Inc.*, 2001 U.S. Dist. Lexis 13588 (M.D.TN Aug. 16, 2001), which involves relying on the training manual directed specifically to unit managers.

[13] 982 F. Supp. 249 (S.D.N.Y. 1997).

[14] The court declined to decide whether out-of-pocket reimbursement equated to a wage reduction.

[15] 30 F. Supp.2d 1010 (M.D. TN 1998).

deductions. Additionally, in a 30-month period, Shoney's made at least 1,229 deductions, affecting 3.5 percent of the total population of managers and assistant managers. Accordingly, there was also an actual practice of making such deductions.

Window of Correction

Employers may have a chance to make good if they have acted incorrectly. In case of certain improper deductions, the FLSA provides a "window of correction."

> The effect of making a deduction which is not permitted...will depend on the facts in the particular case. Where deductions are generally made when there is no work available, it indicates there was no intention to pay the employee on a salary basis. In such a case the exemption would not be applicable to him during the entire period when such deductions were being made. On the other hand, where a deduction...is inadvertent, or is made for reasons other than for lack of work, the exemption will not be...lost if the employer reimburses the employee for such deduction and promises to comply in the future.[16]

"'[I]nadvertence' and 'reasons other than lack of work' [are] alternative grounds," so employers can correct all inadvertent deductions, but only those intentional deductions that were made for reasons other than lack of work.[17] To do so, the employer must reimburse all affected employees for all improper deductions and promise them (and the union representing them, if applicable) future compliance.[18]

The Duties Tests

The duties tests focus on the employee's "primary duty," which is what the employee does that is of primary value to the employer.[19] Situations in which an employee performs both exempt and nonexempt duties will be evaluated based on several factors, but the chief factor is the amount of time spent on nonconforming duties. Employees of a retail or service establishment (which presumptively includes hotels and restaurants), however, "shall not be excluded from the definition of...executive or administrative [employee] because of the number of hours in his workweek which he devotes to activities not directly or closely related to the performance of executive or administrative activities, if less than 40 per [cent] of his hours worked in the workweek are devoted to such activities."[20]

Employers may have a chance to make good if they have acted incorrectly.

Although the time spent on each task is important, it is not controlling. In most instances where an employee spends more than 50 percent of her time performing exempt duties she will be exempt, but an employee may still be exempt even if she devotes less than 50 percent of her time to such activities. Courts look at all relevant facts, including the "relative importance of the [exempt] duties as compared with other types of duties...and the relationship between [her] salary and the wages paid other employees for the kind of nonexempt work performed" by her.[21]

The regulations provide the following example illustrating the concept of primary duty.

> [I]n some departments, or subdivisions of an establishment, an employee has broad responsibilities similar to those of the owner or manager of the establishment, but generally spends more than 50 percent of his time in production or sales work. While engaged in such work he supervises other employees, directs the work of warehouse and deliverymen, ap-

[16] 29 C.F.R. § 541.118(a)(6).

[17] *Auer*, 519 U.S. at 463, 117 S.Ct. at 913.

[18] See: *Yourman v. Giuliani*, 1999 U.S. Dist. Lexis 15700 (S.D.N.Y. Oct. 7, 1999). For a discussion of the disagreement among the courts as to situations involving a pattern or practice of improper deductions, see: *Belcher v. Shoney's, Inc.*, 30 F. Supp.2d 1010 (M.D. TN 1998); and *Hoffman v. Sbarro Inc.*, 982 F. Supp. 249, 256 (S.D.N.Y. 1997).

[19] See: 29 C.F.R. § 103 (discussing primary duty).

[20] 29 U.S.C. § 213(a)(1).

[21] For example, see: 29 C.F.R. §§ 541.103, 541.118, 541.206, 541.304, 541.600.

> proves advertising, orders merchandise, handles customer complaints, authorizes payment of bills, or performs other management duties as the day-to-day operations require. He will be considered to have management as his primary duty.[22]

Separate Tests

The regulations provide separate duties tests for executive and administrative employees.

Executive test. The test to establish whether an employee is an executive comprises two parts, as follows. **(1)** The employee's primary duty is management of the enterprise in which he or she is employed or a customarily recognized department or subdivision thereof, and **(2)** the employee customarily and regularly directs the work of two or more full-time employees (or the equivalent).

The regulations point out that the phrase "a customarily recognized department or subdivision" is intended to "distinguish between a mere collection of men...and a unit with permanent status and function." The employee "must be in charge of and have as his primary duty the management of a recognized unit which has a continuing function."[23]

An executive must customarily and regularly supervise at least two full-time employees or the equivalent. This requirement can be satisfied by any combination of full- and part-time employees adding up to the equivalent of two full-time employees.[24] Moreover, the regulations state the following:

> Section 541.1 requires that an exempt executive employee have the authority to hire or fire...or that his suggestions and recommendations...will be given particular weight. Thus, no employee, whether high or low in the hierarchy of management, can be considered [an executive] unless he is directly concerned either with the hiring or the firing and other change of status of the employees under his supervision, whether by direct action or by recommendation to those to who the hiring and firing functions are delegated.[25]

Administrative test. To meet the administrative test, the employee's primary duty must require the exercise of discretion and independent judgment, which consists of performing office or nonmanual work directly related to management policies or general business operations of the employer or its customers. In short, administrative employees are in positions where they must make decisions on their own.

As the statute puts the matter, the "exercise of discretion and independent judgment involves the comparison and the evaluation of possible courses of conduct and acting or making a decision after the various possibilities have been considered...free from immediate direction or supervision and with respect to matters of significance." It "does not necessarily imply that the decisions...must have a finality that goes with unlimited authority and a complete absence of review."[26]

Furthermore, the phrase "directly related to management policies or general business operations...describes those types of activities relating to the administrative operations of a business as distinguished from 'production' or, in a retail establishment, 'sales' work."[27]

> [T]he phrase limits the exemption to persons who perform work of substantial importance to the management or operation of the business.
>
> The administrative operations of the business include the work performed by so-called white-collar employees engaged in "servicing" a business as, for example, advising the management, planning, negotiating, representing the company, purchasing, promoting sales, and business research and control....

[22] 29 C.F.R. § 103.

[23] Nevertheless, the regulations provide: "an otherwise exempt employee [does not] lose the exemption merely because he or she draws the persons under his supervision from a pool, if other factors are present which indicate that he is in charge of a recognized unit with a continuing function." 29 C.F.R. § 541.104(a). See: 29 C.F.R. § 541.1 *et seq.* (discussing executive exemption).

[24] 29 C.F.R. § 541.105.

[25] 29 C.F.R. § 541.106.

[26] See: 29 C.F.R. §§ 541.207(a)&(e); also: 29 C.F.R. § 541.2 *et seq.* (discussing the administrative exemption).

[27] 29 C.F.R. § 541.205(a).

> [The phrase] is not limited to persons who participate in the formulation of management policies or in the operation of the business as a whole. Employees whose work is "directly related" to management policies or to general business operations include those [whose] work affects policy or whose responsibility it is to execute or carry it out. The phrase also includes a wide variety of persons who either carry out major assignments in conducting the operations of the business, or whose work affects business operations to a substantial degree.[28]

Illustrative Cases

Employee misclassification recently cost Waffle House more than $3,000,000.[29] Waffle House staffed each of its restaurants with a unit manger, whom it classified as an exempt executive. In a class action brought on behalf of current and former unit managers, the district court found they were misclassified. Among the facts that the court took into account were the following:

- Unit managers served as grill cook for the busiest of three shifts;
- The unit managers' training manual stated that the primary objective of the training was "to become a proficient grill operator. A secondary objective was to gain exposure to the daily management duties and responsibilities";
- Unit managers often substituted for absent hourly employees; and
- Hourly employees regularly performed the duties of absent unit managers.

Finding that the unit managers worked an average of 89 hours per week, the court awarded them $2,868,841.50 (plus prejudgment interest).

In contrast, in *O'Neill-Marino v. Omni Hotels Management Corp.*, the court determined that the hotel's director of conference services was properly classified as an administrative employee.[30] The plaintiff's responsibilities included negotiating contracts with clients, coordinating various hotel operations to serve the clients, and participating in management meetings and budget forecasting. Thus, the court found she was engaged in "office or non-manual work directly related to management policies or general business operations." Moreover, she regularly exercised discretion and independent judgment in negotiating contracts and price terms. The court added that the fact that "she may have negotiated within pre-set limits or that her contracts were subject to approval by a sales manager does not remove her from the purview of the exemption."[31]

To meet the administrative test, the employee's primary duty must require the exercise of discretion and independent judgment.

Similarly, in *Reich v. Avoca Motel Corp.*, the court found that individual managers of four rural motels were properly classified as exempt.[32] The managers ran the day-to-day operations of the motels, including interviewing and hiring applicants, training and evaluating employees, scheduling and supervising employees, serving as the motel's chief liaison to guests, and as its "sales agent." Even though the managers also performed routine tasks (e.g., laundry, cleaning the lobby, taking reservations, and shoveling snow), the court of appeals affirmed the district court's ruling that their primary duties were administrative.[33] In doing so, the court rejected plaintiff's

[28] *Wright v. Aargo Security Services, Inc.*, 2001 U.S. Dist. LEXIS 882 *30-33 (S.D.N.Y. February 1, 2001). The *Wright* court noted, however, that: "decisions...concerning relatively unimportant matters are not [enough]...the discretion and independent judgment exercised must be real and substantial, that is, they must be exercised with respect to matters of consequence.... The decisions made as a result of the exercise of discretion and independent judgment may consist of recommendations for action rather than the actual taking of action."

[29] *Cowan v. Treetop Enterprises, Inc.*, 2001 U.S. Dist. Lexis 13588 (M.D.TN Aug. 16, 2001).

[30] 2001 U.S. Dist. LEXIS 2138 (S.D.N.Y. March 2, 2001).

[31] 2001 U.S. Dist. Lexis 2138 at *26.

[32] 82 F.3d 238 (8th Cir. 1996).

[33] The plaintiff had focused on the executive exemption, but the court found the managers were administrative employees because their "duties fall under the rubric of 'advising the management' and 'promoting sales,' which are specifically included in the definition of administrative duties." See: *Avoca Motel*, 82 F.3d at 240 n.5.

argument that time spent "on call" (pursuant to the employer's policy requiring managers to live in the hotel) should count as time spent performing nonexempt work, because the court found that such time was "related" to their management duties.[34]

Double Damages

Failure to pay an employee proper overtime can result in liability for unpaid overtime plus prejudgment interest, and liquidated damages equal to the amount of unpaid wages, as well as attorneys' fees and costs. To avoid liquidated damages, the employer must prove that the violation was "in good faith" and that the belief that the employee was exempt was based on reasonable grounds. The chances of this may be slim, as the court commented in a New York restaurant case: "The burden on the employer is a difficult one to meet, however, and double damages are the norm, single damages the exception."[35] In another case, a court held:

> To establish "good faith" a defendant must produce plain and substantial evidence of at least an honest intention to ascertain what the act requires and to comply with it. "Good faith" in this context requires more than ignorance of the prevailing law or uncertainty about its development. It requires that an employer first take active steps to ascertain the dictates of the FLSA and then move to comply with them. That a company did not purposefully violate the provisions of the FLSA is insufficient.[36]

Moreover, as a court wrote in a case involving a local government, "ignorance of the law is insufficient to establish good faith. Adherence to industry practice, when such practice violates the FLSA, is likewise insufficient."[37]

Damages under the FLSA need not be proven precisely, as more than one court has pointed out. For instance, one court held:

> The burden of proving uncompensated hours worked by employees is reduced in a Fair Labor Standards Act case. The Secretary [of labor] may establish a *prima facie* case of unpaid wages by introducing testimony from representative employees as to unpaid hours worked or other evidence sufficient to show the amount and extent of that work as a matter of just and reasonable inference.
>
> Once the secretary has established a *prima facie* case, *the burden then shifts to the employer to prove the precise extent of uncompensated work.* If the employer fails to produce such evidence, the court may then award damages to the employee, even though the result be only approximate.[38] [emphasis added]

The court in the *Waffle House* case also dealt with that issue, stating:

> Where the employer fails to maintain records in accordance with 29 U.S.C. § 211 (c) and plaintiffs prove actual work without proper compensation, an approximation of damages by the court is appropriate once the fact of injury is proved. In such instances, the employer has the burden of disputing plaintiff's approximation and proving the precise amount of work performed.[39]

Personal liability. An unusual feature of the FLSA is the matter of personal liability. As the statute states: "Any person acting directly or indirectly in the interest of an employer in relation to an employee" may be personally liable for his or her actions.[40] Under this provision a company's owners, officers, managers, and supervisors can face personal liability—without the traditional showing necessary to pierce the corporate veil.[41]

[34] See: 29 C.F.R. § 541.108.

[35] See: *Ayres v. 127 Restaurant Corp.*, 12 F. Supp.2d 305 (S.D.N.Y. 1998).

[36] *Dingwall v. Friedman Fisher Assoc., P.C.*, 3 F. Supp.2d 215, 222 (N.D.N.Y. 1998).

[37] *Hellmers v. Town of Vestal, NY*, 969 F. Supp. 837 (N.D.N.Y. 1997).

[38] *Metzler v. Hickey's Carting, Inc.*, 1997 U.S. App. Lexis 24445 *4 (2d Cir. 1997); citing *Anderson v. Mt. Clemens Pottery Co.*, 328 U.S. 680 (1946).

[39] 2001 U.S. Dist. Lexis 13588 at *20-21.

[40] 29 U.S.C. § 203(d).

[41] The expression "corporate veil" refers to the protection ordinarily afforded employees of a corporation for their actions. In most cases the corporation is liable, rather than the individuals themselves, who are under the "corporate veil."

The key question in this regard is, did the person "possess the power to control the workers in question, with an eye to the 'economic reality' presented by the facts of each case?"[42]

The statue of limitations for a finding of personal liability is two years, or three years if the violation is found to be willful. To extend the deadline by that additional year, a plaintiff must show "that the employer either knew or showed reckless disregard for the matter of whether its conduct was prohibited by the statute."[43]

Check Actual Duties

Employers should review their pay practices to ensure that all employees are properly classified under the FLSA's provisions. Moreover, employers must implement a system to prevent improper deductions that could violate the salary test, and develop written job descriptions delineating the duties of each position within the company. The lesson of the cases above is that the employee's actual duties—not the job description—will control whether the individual is exempt from the FLSA's wage-and-hour provisions. Setting aside the matter of liability, it makes sense from an organizational standpoint to pay people appropriately according to their duties. Thus, taking these steps to ensure that a company's pay practices comply with the FLSA is a worthwhile endeavor.

[42] *Herman v. RSR Security Services Ltd.*, 172 F.3d 132, 139 (2d Cir. 1998), affirming liability of the 50-percent owner of company who, among other things (1) had authority to hire employees, (2) occasionally controlled their conditions of employment, and (3) ordered the company to pay workers as employees rather than independent contractors. Compare to: *Johnson v. A.P. Products, Ltd.*, 934 F. Supp. 625 (S.D.N.Y. 1996), dismissing claims against an individual where complaint did not allege that she exercised control over the acts or omissions in question. There is also criminal liability, as stated in (29 U.S.C. § 216(a): "Any person who willfully violates any of the provisions of section 215 of this title shall upon conviction thereof be subject to a fine of not more than $10,000, or to imprisonment for not more than six months, or both." Despite the continuing validity of this provision, it is not likely to be invoked. For example, in the Second Circuit, the latest reported decisions involving criminal prosecution for an F.L.S.A. violation are from 1969. See: *U.S. v. Stanley*, 416 F.2d 317 (2d Cir. 1969), affirming the conviction of the company's president; *U.S. v. Drago*, 1969 U.S. Dist. LEXIS 10622 (May 13, 1969), individual employer convicted.

[43] *McLaughlin v. Richland Shoe Co.*, 486 U.S. 128, 133 (1988).

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