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OUR FILE NUMBER:

March 27, 2020

MEMORANDUM

TO: File

FROM: JNL

RE: Exemption Status after Reduction in Salary and Work Schedule

I. INTRODUCTION AND QUESTION PRESENTED

In today's current economic environment, many California employers face tremendously difficult choices, including determining whether to reduce employee work schedules and/or pay or conducting temporary layoffs. For exempt employees, this raises unique questions. In particular, can an employer reduce exempt employees' salaries without jeopardizing their exempt status?

II. SHORT ANSWER

Yes, an employer may be able to reduce an employee's salary without jeopardizing the employee's exempt status, so long as the employee's salary satisfies the minimum salary requirement for the exemption. There are several options, each carrying its own level of risk. First, if the employment relationship is at-will, employers may reduce exempt employees' salaries without simultaneously reducing their work schedules - notwithstanding federal and California anti-discrimination laws. However, employers should not reduce salaries below the

minimum salary requirement for the exemption or with such frequency that the salary is the functional equivalent of an hourly wage. Employers should also attribute the salary reduction to a loss of income and need to reduce operating costs, as opposed to a decline in work, to demonstrate that the exempt employee's pay is not based on the quantity of work performed. This would be the most conservative approach.[1]

Second, employers may elect to implement a reduced schedule for exempt employees, along with a simultaneous pro rata reduction in their salary. This is a viable, but riskier option as no controlling California authority has directly addressed the issue. The DLSE weighed in with two conflicting opinion letters, one on March 12, 2002 and the other on August 19, 2009. The March 12, 2002 letter relied upon a federal district court opinion in New York, and opined that federal regulations preclude an employer from reducing an exempt employee's salary during a period in which a company operates during a shortened workweek due to economic conditions.

The DLSE's August 19, 2009 letter considered an employer seeking guidance about its proposal to temporarily reduce its exempt employees' work schedule from 5 days per week to 4 days per week, and a concurrent 20% pro rata reduction in pay, out of business necessity, during the economic downturn at the time. The DLSE rejected the March 12, 2002 letter, primarily in light of two intervening decisions out of the Tenth Circuit Court of Appeals, which held that employers could implement a prospective reduction in salary to meet the employer's business

[1] If an employer reduces an employee's salary below the minimum requirement to qualify for an exemption, the employee should be reclassified as non-exempt and comply with the Company's timekeeping and meal and rest break policies. The employer should also pay the employee for all overtime worked and revise the employee's wage statements to provide all requisite information required under Labor Code section 226 (e.g., hours worked, applicable hourly rates, etc.)

needs so long as it is not done with such frequency that the salary is the functional equivalent of an hourly wage. *Archuleta v. Wal-Mart Stores, Inc.* (10th Cir. 2008) 543 F.3d 1226; *In re Wal-Mart Stores, Inc.* (10th Cir. 2005) 395 F.3d 1177. The DLSE found it important that the proposed reductions were for a temporary period due to economic conditions. Its reasoning is based upon several United States Department of Labor Wage and Hour opinion letters, which found employers had demonstrated their reductions in exempt employees' salaries were "bona fide" when the reduction was temporary or infrequent, and due to economic conditions, and, therefore, not designed to circumvent the salary basis test. *See, e.g.*, U.S. Dept. of Labor ("DOL") Wage and Hour Letters, dated November 13, 1970, March 4, 1997, February 23, 1998, June 3, 1999, and June 25, 2004.

Finally, employers may also consider temporarily reclassifying exempt employees as non-exempt in order to pay them on an hourly basis instead. However, this option entails its own risk and subjects an employer to penalties by the Department of Labor or the California Labor Commissioner for employee misclassification should a government agency determine that periods of classifying an employee as exempt was a "sham" to avoid overtime obligations. To reduce risk, an employer who selects this option should tie the change in classification to a change in job duties or reduction in salary below the minimum requirement for the exemption, if possible, as opposed to a reduction in work. Moreover, changing an employee's exempt status triggers a separate slate of protections afforded to non-exempt employees under the Labor Code and IWC Wage Orders. This is includes, but is not limited to, recording all time worked, paying overtime, providing meal and rest breaks, and including all requisite information on itemized

wage statements. As such, employers should have sufficient documentation justifying the reasons for reclassifying any employees and refrain from doing so on a recurring basis.

III. DISCUSSION

Since California law pertaining to exemption status is patterned after federal law under the Fair Labor Standards Act ("FLSA"), it is appropriate to consider federal authorities in interpretation of such state laws. *Bell v. Farmers Ins. Exchange* (2001) 87 Cal.App.4th 805. However, where California law is more protective for employees than federal law, courts should not rely on federal authorities in interpreting the IWC Wage Orders or the Labor Code. *Ramirez v. Yosemite Water Co., Inc.* (1999) 20 Cal.4th 785, 798. It is important to bear that in mind when comparing similarities and differences between California and federal law regarding exempt employees.

1. Courts Narrowly Construe Exemptions against Employers under California Law But Give a Fair Reading of the Plain Text of FLSA

A key distinction entails a relatively recent development in how courts construe exemptions under California law versus the FLSA. Both California and federal law presume that employees are non-exempt and place the burden on the employer to establish that the exemption exists. *Ramirez*, *supra*, 20 Cal.4th at 794; *Hodge v. Superior Court* (2006) 145 Cal.App.4th 278; and *Walling v. General Industries Co.* (1947) 330 U.S. 545. In California, exemptions are ***narrowly construed*** against the employer and their application is limited to those employees plainly and unmistakably within their terms. *Nordquist v. McGraw-Hill Broadcasting* (1995) 32 Cal.App.4th 555. Until recently, courts interpreting the FLSA applied the same construction

against employers. Then, in 2018, the United States Supreme Court changed FLSA jurisprudence by rejecting the longstanding principle that exemptions are to be construed narrowly. *Encino Motorcars, LLC v. Navarro* (2018) 138 S.Ct. 1134, 1142. The Court held that "[b]ecause the FLSA gives no 'textual indication' that its exemptions should be construed narrowly, 'there is no reason to give them anything other than a ***fair (rather than narrow) interpretation***.'" *Id*. (Citation omitted).

The Court's decision will have broader implications for all employers that rely on any FLSA exemption for their employees, as employees challenging their exemption status will no longer have the advantage of arguing that FLSA exemptions must be narrowly construed. Instead, courts must analyze challenges to exemption status under the FLSA, but not those under the California Labor Code or Wage Order, through a "fair reading" of the plain text. *Id*. at pgs. 1142-1143. However, challenges to exemption status under the California Labor Code or the IWC Wage Orders will continue to be narrowly construed against employers. Furthermore, case law applying the "fair interpretation" of the FLSA, will have limited application to the interpretation of California law since California affords greater protection to employees.

2. Difference in the Minimum Salary Requirements

The clearest distinction between California and federal law is the minimum salary required for exempt employees. Exemptions for executive, administrative, and professional employees are proper only where the employee is primarily engaged in the duties that meet the test of the exemption, customarily and regularly exercises discretion and independent judgment in performing those duties. Cal. Labor Code § 515(a); 29 CFR 541.700, *et seq*. Under

California law, an exempt employee must earn a monthly salary equivalent of no less than two times the state minimum wage for full-time employment, while under federal law the minimum salary is a fixed amount. 29 CFR 541.600, *et seq*. Based on calculations of the current minimum wage in California for 2020, the minimum annual salary amount for most exempt employees is $49,920.00 for employers with 25 or fewer employees and $54,080.00 for employers with more than 25 employees. As of January 1, 2020, under federal law, an exempt executive, administrative or professional employee must earn at least $35,568.00 per year. See, Dept. of Labor, Final Rule, September 27, 2019.

With greater protections afforded California employees, the federal threshold is inapplicable and employers in this state should pay most exempt employees based on the California minimum salary requirements.

3. What About Deductions from an Exempt Employee's Pay?

California and federal regulations pertaining to deductions of an exempt employee's salary parallel each other for the most part. *See, e.g.*, Department of Labor Standards and Enforcement, Enforcement Policy and Interpretations Manual ("DLSE Manual"), § 51.6.1, et seq.; *Conley v. Pacific Gas & Electric Co.* (2005) 131 Cal.App.4th 260 ("*Conley*"); *Negri v. Koning & Associates* (2013) 216 Cal.App.4th 392 ("*Negri*"); and 29 CFR 541.602 and 603. Set forth below are the general rules for deducting pay from an exempt employee's salary:

• Do not drop the salary below the minimum threshold to qualify for an exemption. DLSE Manual, § 51.6.1; DLSE Opinion Letter 2002.05.06.

• No deductions may be made for quality or quantity of work performed. DLSE Manual, § 51.6.8; 29 CFR 541.602(a); *Conley* at p. 267; *Negri* at p. 398.[2]

• Salary may not be prorated for work less than full time, but there is no obligation to pay salary to an exempt employee who has performed ***no work*** during the workweek. DLSE Manual, § 51.6.3; 29 CFR 541.602(a)(1); *Negri* at p. 398.

• Salary is not subject to deduction unless the employee voluntarily absents himself for personal reasons. DLSE Manual, § 51.6.1; 29 CFR 541.602(b)(1); *Conley* at p. 267.

• No deductions from salary may be made for absences occasioned by the employer or by the operating requirements of the business, unless there is no work for the entire week. DLSE Manual, § 51.6.14; 29 CFR 541.602(a)(1) and (2); *Negri* at p. 398.

• No deductions may be made for jury duty, attendance as a witness, or for temporary military leave unless it is for a full week. DLSE Manual § 51.6.21.1; *compare* 29 CFR 541.602(a)(1) and (b)(3), permitting salary to be offset by jury fees, witness fees or military pay.

• Work performed outside of work site (i.e. remote work) qualifies as work performed. DLSE Manual § 51.6.12; U.S. Dept. of Labor Wage and Hour Letter ("DOL Opinion Letter"), July 21, 1997; and DLSE Opinion Letter 2002.04.08.

• Docking salary as a disciplinary action may nullify the employee's exempt status, though deductions of pay may be made for unpaid disciplinary suspensions of one or more full

[2] Employers should attribute the salary reduction to a loss of income and need to reduce operating costs, as opposed to a decline in work, to demonstrate that the exempt employee's pay is not based on the quantity of work performed.

days imposed in good faith for infractions of workplace conduct rules, pursuant to written policies applicable to all employees. 29 CFR 541.602(b)(5); DLSE Opinion Letter 2002.05.06.

• If the employee has a voluntary absence of a full day or more, then a pro-rata deduction is permitted, and it does not affect exempt status. But if the employee performs ***any work*** during the work day, then no deduction may be made from the salary as a result of what would otherwise be a "partial day absence." DLSE Manual, § 51.6.14.3; 29 CFR 541.602(b)(1); *Conley* at p. 267.

• A pro rata deduction from salary is permitted for voluntary absences, but in no event may the employee's salary be reduced by more than one-fifth for a day of absence (i.e. if an exempt employee only works a 4-day weekly schedule and misses one day, then the employer cannot deduct more than one-fifth of the employee's weekly salary). DLSE Manual, § 51.6.10; DOL Opinion Letter, July 21, 1997.

• No deductions may be made from the salary of an exempt employee for sickness or accident unless it exceeds the weekly period. DLSE Manual, § 51.6.15.2; 29 CFR 541.602(a)(1) and (b)(1).

• Federal law allows an employer with a bona fide sick leave plan to deduct accrued leave to pay the salary obligation for a "partial day absence" for illness and injury, but does not allow a deduction from the salary for such partial day absence in the event the employee's eligibility for the leave has not yet vested or the employee has exhausted his or her leave. DLSE Manual, § 51.6.15.3; 29 CFR 541.602(b)(1) and (2); DOL Opinion Letter, 2006 WL 2792446 (September 14, 2006). California law follows federal law regarding partial day absences for time off due to

sickness or other personal reasons and permits deductions from the applicable bank of accrued leave time, i.e. bona fide sick leave, vacation, or paid time off plans, for partial day absences of any length of time, including less than four hours. *Conley v. Pacific Gas & Electric Co.* (2005) 131 Cal.App.4th 260, 267-270; *Rhea v. General Atomics* (2014) 227 Cal.App.4th 1560, 1569 and 1575.

• If it is found that the employer has an actual practice of making improper deductions, the exemption is lost only during the time period in which the deductions were made for employees in the same job classification working for the same managers responsible for the actual improper deductions. 29 CFR 541.603(a)-(c); *Negri* at p. 400.

4. Can the Employer Reduce the Work Schedule of Exempt Employees While Simultaneously Reducing Their Salaries on a Pro Rata Basis?

Some federal authorities expressly interpret the FLSA to permit an employer to simultaneously reduce work schedules and salaries of exempt employees to accommodate business needs. *Archuleta v. Wal-Mart Stores, Inc.* (10th Cir. 2008) 543 F.3d 1226; *In re Wal-Mart Stores, Inc.* (10th Cir. 2005) 395 F.3d 1177; and *Caperci v. Rite Aid Corporation* (Dist. Mass. 1999) 43 F.Supp.2d 83*; see also* DOL Opinion Letter, November 13, 1970; and DOL Opinion Letter, February 23, 1998. The only stated caveat was that "[i]f . . . the salary changes are so frequent as to make the salary the functional equivalent of an hourly wage, we will treat the 'salary' as a sham and deny the employer the FLSA exemption . . ." *Archuleta v. Wal-Mart Stores, Inc.*, 543 F.3d at p. 1231.

This position has not been adopted by all federal circuit courts and has been met with some criticism. *See, e.g.*, *Harvey v. Homebound Mortgage, Inc.* (2d Cir. 2008) 547 F.3d 158; and *Alawar v. Trican Well Services, L.P.* (W.D. Texas 2019) 397 F.Supp.3d 873, 889-890. In *Alawar*, the District Court refused to adopt the Tenth Circuit's reasoning in light of the perceived inconsistency with the language of 29 C.F.R § 541.602(a)(2) (reducing the pay of an exempt employee's predetermined compensation for absences due to the employer's operating requirements, such employee's compensation no longer qualifies as a salary and their exempt status is undermined.) *Id*. at 889.

In 2002, the California Labor Commissioner issued an opinion letter that affirmed the DLSE's policy to follow federal regulations regarding the salary basis test and opined that federal regulations preclude an employer from reducing an exempt employee's salary during a period which a company operates during a shortened workweek due to economic conditions. DLSE Opinion Letter 2002.03.12.

However, during the last recession, the DLSE issued another opinion letter in 2009 rejecting the March 12, 2002 Opinion Letter primarily in light of the intervening *Wal-Mart* cases out of the Tenth Circuit Court of Appeals. DLSE Opinion Letter 2009.08.19. In that opinion letter, the DLSE considered whether an employer could temporarily reduce the work schedules of exempt employees from five days per week to four days per week, with a simultaneous pro rata (20%) reduction in salary, in order to avoid total layoffs during the economic downturn at that time. *Id*. As presented, the DLSE found that neither the Labor Code and IWC Wage Order provisions, nor the federal law upon which the pertinent provisions of California law are based,

prohibit employers from implementing a proposed reduction in the work schedule and salary of the affected exempt employees. *Id*.

The DLSE rejected its March 12, 2002 opinion letter because the intervening Tenth Circuit *Wal-Mart* cases disapproved the reasoning in *Dingwall v. Friedman Fisher Associates, P.C.* (N.D. N.Y. 1998) 3 F.Supp.2d 21, the district court case upon which the DLSE had previously relied. In particular, *In re Wal-Mart Stores, Inc.* clarified that federal regulations 29 CFR 541.602 only precluded deductions in the current pay period, ***not reductions in future salary***. *In re Wal-Mart Stores, Inc.*, 395 F.3d at p. 1188 (emphasis added). The DLSE found it important that the proposed reductions were for a temporary period due to economic conditions. Its reasoning is based upon several United States Department of Labor Wage and Hour opinion letters, which found employers had demonstrated their reductions in exempt employees' salaries were "bona fide" where the reductions were temporary or infrequent, and due to economic conditions, and, therefore, not designed to circumvent the salary basis test. *See, e.g.*, U.S. Dept. of Labor ("DOL") Wage and Hour Letters, dated November 13, 1970, March 4, 1997, February 23, 1998, June 3, 1999, and June 25, 2004. *Id*.

Moreover, under the *Wal-Mart* cases, it appears neither economic slowdowns or temporary limitations on reductions are necessary so long as the employer does not frequently make such changes. In those cases, which entailed exempt pharmacists' compensation plans, not economic slowdowns, the Tenth Circuit held that "an employer may prospectively reduce salary to accommodate the employer's business needs unless it is done with such frequency that the salary is the functional equivalent of an hourly wage." *Archuleta v. Wal-Mart Stores, Inc.*, 543

F.3d at 1231; citing *In re Wal-Mart Stores, Inc.*, 395 F.3d at 1184. In *Archuleta*, the Court cited to the November 13, 1970 DOL Wage and Hour Letter for the proposition that an employer could change all of its exempt employees' salaries twice in one year without altering their exemption status. *Archuleta* at p. 1232 citing DOL Wage and Hour Letter, dated November 13, 1970 (employer reduced employees from a 5-day workweek to 4-day workweek, with a pro rata reduction in pay, but for only 5 out of the 52 workweeks.)[3] The holdings in the *Wal-Mart* cases also infer that a permanent reduction in future salary and work schedule does not impact exempt status, since that would only be a one-time change, so long as it otherwise continues to meet the salary basis test.

In January 2020, the United States Dept. of Labor issued an opinion letter pertaining to whether per-project payments, paid in equal pre-determined installments, satisfied the salary basis test for exemption. DOL Opinion Letter, January 7, 2020. The employer proposed the scenario where the employee works on one project for 40 weeks, while paid 20 bi-weekly installments of $2,000, and an overlapping simultaneous project of only 8 weeks, while paid 4 bi-weekly installments of $1,500. *Id*. The result would have been a temporary increase in compensation in the amount of four bi-weekly installments of $5,500 ($4000 + $1,500), followed by a reduction in compensation back down to bi-weekly installments of $4,000. *Id*. The employer and employee agreed that, on unusual occasions after a project commences, if

[3] An example of a "sham exception" to the salary basis test is if an employer had a regular practice each Friday of informing its professional staff of the work schedule for the following week and making prospective adjustments in compensation to reflect any changes. Archuleta at p. 1232; citing *Caperci v. Rite Aid Corp.* (D. Mass. 1999) 43 F.Supp.2d 83, 97, fn. 14; and *Thomas v. County of Fairfax* (E.D. Va. 1991) 758 F.Supp. 353, 355-57 (granting summary judgment in favor of fire fighters over compensation scheme tied to a bi-weekly schedule rotation, and corresponding pay, consisting of 96, 120, or 144 hours).

changes to the scope of the project are significant enough, they may renegotiate the total compensation paid to the employee prospectively. *Id*.

The DOL approved the pay structure, even if the scope of a project changed prospectively, such that the employee's pay was also prospectively increased or decreased as well. *Id*. In so doing, the letter reiterated the DOL's policy that "employers do not violate the salary basis test by prospectively reducing the salary of exempt employees under certain conditions." *Id*. The DOL relied upon the same authority as the August 19, 2009 DLSE Opinion Letter, citing *Archuleta v. Wal-Mart Stores, Inc.* (10th Cir. 2008) 543 F.3d 1226; DOL Opinion Letter, November 13, 1970 (advising that an employer can prospectively reduce its 52 five-day workweeks per year to 47 and have its employees work five four-day work weeks at the end of each year, without losing its exemption; and DOL Opinion Letter, February 23, 1998 (concluding that an employer can reduce its salaried employees' workweek because of a temporary work shortage without losing the exemption).

In short, the DOL's guidance in this letter is promising for California employers seeking options to maintain their exempt employees during difficult economic times, including a simultaneous reduction in work and salary option. However, although these authorities are persuasive, the California DLSE Opinion Letters, federal DOL Opinion Letters, and decisions from the Tenth Circuit Court of Appeals in the *Wal-Mart* cases are not binding on California courts. Therefore, there is no definitive answer as to whether or not employers may elect to reduce an exempt employee's workweek and salary without losing the exemption.

5. Practical Guidance for California Employers

Despite the lack of definitive guidance, there are options for employers. First, if the employment relationship is at-will, employers may reduce exempt employees' pay, but should consider doing so ***without any*** simultaneous reduction in their work schedule - notwithstanding federal and California anti-discrimination laws, of course. However, employers should not reduce salaries below the minimum salary requirement for the exemption or with such frequency that the salary is the functional equivalent of an hourly wage. *Archuleta v. Wal-Mart Stores, Inc*., 543 F.3d. at 1231; and *In re Wal-Mart*, 395 F.3d at 1084. Employers should also attribute the salary reduction to a loss of income and need to reduce operating costs, as opposed to a decline in work, to demonstrate that the exempt employee's pay is not based on the quantity of work performed. This would be the most conservative approach.

Second, electing to implement a reduced schedule for exempt employees, along with a pro rata reduction in salary remains a viable, albeit riskier, option. For some employers, it may be impractical to maintain the current work schedules of certain exempt employees, due to temporary work shortages, such that an isolated and temporary reduction in work and salary makes the most practical sense for ***both*** the employer and the employee, until business conditions permit a return to the full schedules and salaries.

Finally, employers may also consider temporarily reclassifying exempt employees as non-exempt in order to pay them on an hourly basis instead. The DOL has opined that converting exempt employees may not necessarily "affect their status during other periods of employment when all the requirements for the exemption are satisfied, absent evidence of intent

to circumvent the salary basis requirement." *See*, DOL Opinion Letter November 13, 1970 and DOL Opinion Letter, June 24, 2004. For example, recurring changes in an employee's status would lead to an "across-the-board denial of the exemption." *Id*.

However, this option entails its own risk and subjects an employer to penalties by the Department of Labor or the California Labor Commissioner for employee misclassification should a government agency determine that periods of classifying an employee as exempt was a "sham" to avoid overtime obligations. To reduce risk, an employer who selects this option should tie the change in classification to a change in job duties or reduction in salary below the minimum requirement for the exemption, if possible, as opposed to a reduction in work. Moreover, changing an employee's exempt status triggers a separate slate of protections afforded to non-exempt employees under the Labor Code and IWC Wage Orders. This is includes, but is not limited to, recording all time worked, paying overtime, providing meal and rest breaks, and including all requisite information on itemized wage statements. As such, employers should have sufficient documentation justifying the reasons for reclassifying any employees and refrain from doing so on a recurring basis.