

# Correcting Wage and Hour Misclassification Errors

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California employers are burdened with more wage and hour “gotchas” than any other state. From mandatory meal periods and required rest breaks to daily overtime requirements, it is the rare employer that is violation-free.

One of the most common errors among California employers is the misclassification of exempt employees as non-exempt, and vice-versa. Employers regularly ask for advice about how to correct a misclassification error without waving a red flag to litigious employees.

## **Classification of Employees as Exempt or Non-Exempt**

In California, an employee may be classified as exempt only when the employee’s salary and duties comply with the required legal standards to meet one of the available exemptions. First, to be exempt, the employee must earn twice the minimum wage for a full-time, 40-hour per week position. With the current minimum wage set at \$10 per hour in most cities, this means that the exempt employee must earn a minimum annual salary of \$41,600. This rate goes up in cities and counties with higher minimum wages, and will continue to rise as California increases the statewide minimum wage over the next several years.

The minimum annual salary is not prorated for part-time employees. In other words, if an employee would earn \$41,600 for a full-time position, but works only part-time, the employee must still earn \$41,600 for the part-time position, regardless of hours worked. It is also advisable to pay the exempt employee a salary higher than this minimum: employees making a salary that

meets or barely exceeds the minimum will be subjected to greater scrutiny of the exempt classification.

Assuming that the employee earns the requisite minimum salary, the employee also must perform exempt duties (as defined by the applicable category of exemption) for more than 50% of employee's working time. If the employee has several exempt duties (such as hiring, firing, evaluation of employees, discretionary spending, policy-making authority or other indices of exempt status) but performs non-exempt duties (such as inventory, sales, customer service, data entry, or other non-exempt tasks) more than 50% of the time, the employee cannot be exempt. A classic example is a manager in a small retail operation with only two employees on shift: the manager is the only "supervisor" on the floor and is technically "managing" 100% of the time, but typically performs standard non-exempt employee duties more than 50% of the time while assisting customers throughout the day, simply because it does not make good business sense to employ a manager merely to stand by and "supervise" another employee.

With a myriad of factors to consider, misclassification of exempt status is distressingly common. Sometimes the misclassification is due to a misunderstanding of the law or the employee's position. In other instances, it may be due to a simple clerical error. For example, an employee's offer letter might refer to the position as exempt, but also mistakenly reference that overtime will be paid. An applicant may be brought in as a non-exempt employee, and management may later determine that the position was exempt after all. Or, an employee is brought in as exempt and is not provided with meal or rest breaks or paid for overtime work, and the company later realizes that the employee should have been classified as non-exempt from the start. What is a company to do?

### **Converting a Non-Exempt Employee to Exempt Status**

As a starting point, when an employee has been treated as non-exempt but could have been classified as exempt, the company's best option is simply to move the employee into an exempt classification in the next month or pay period, after providing written notice of the change to the employee. It is not a violation of law to treat arguably exempt employees as non-exempt. Employers may not recover past overtime pay or recover any damages for providing meal and rest periods to employees who were incorrectly classified as non-exempt. Any corrections to

wages or benefits must be made on a going-forward basis in almost every case, with very little exception.

If the employee was offered overtime at the time of hire or has been working overtime with additional compensation, the employee may now be upset about the change of classification. In this case, the employer has two options: maintain the employee's non-exempt status to keep the peace with the employee, or move the employee to exempt status and explain to the employee why the change is appropriate for the employee's position. Most employees will be pleased with what is commonly perceived as a "promotion" to exempt status. Remind employees that they will no longer have to keep time records and will not be docked in pay for missing partial days of work.

Ultimately, the employer has the unilateral right to make this classification change: in the absence of an employment contract for a specified term, the employer is permitted to alter any terms and conditions of employment in management's discretion on a going-forward basis (but not retroactively). That said, when it comes to reclassification of employee status, employers should work with employment law counsel to analyze the employee's eligibility for exempt status before making that change. An unhappy employee is more likely to challenge that classification and file a wage and hour claim against the company, making it even more important to confirm that the classification is legally viable.

### **Converting an Exempt Employee to Non-Exempt Status**

It is admittedly more challenging to convert a misclassified exempt employee to non-exempt status. Most exempt employees are unhappy about having to track their working time on time cards, take required rest and meal breaks, or be docked in pay for hours missed. The benefit of additional overtime pay is not much of an incentive if overtime is rarely needed, or the employee does not wish to work overtime in any event.

Employee morale is not the only concern when a non-exempt employee has been misclassified as exempt. Exempt employees do not keep time records, as required by California law. This means that a reclassified employee who now is due overtime pay may claim any number of overtime hours worked, and without time records, the employer has no meaningful opportunity to challenge the employee's assertion. Exempt employees also do not receive mandated rest breaks; a reclassified employee may be due an hour of pay as a penalty for every day that the

rest periods were not provided. Exempt employees often do not take timely meal periods; a reclassified employee may be due another hour of pay as a penalty for every day that a meal period was missed, late or short. Misclassification cases carry additional penalties and statutory attorneys' fees as well, substantially increasing the potential damages to an employer.

Upon discovering that a non-exempt employee has been misclassified as exempt employee, the employer has several options:

1. ***Inform the employee of the misclassification, determine any damages that may be due and pay the employee for those damages.*** This future claim may manifest as a single-employee claim, or a multi-employee class action. While continuing a known misclassification is risky to employers as well as individual owners, operators and managing agents, the employer who chooses to “look the other way” can take several additional steps to avoid the risk of a claim or to diminish the damages in the event of a claim.

First, the employer can develop a strong job description supporting the exempt classification, which will direct the employee toward exempt duties as well as support an argument for the exemption later. Provide the employee with a copy of the arguably-exempt job description and ask the employee to keep a daily activity or project log, noting the amount of time he spends on various tasks throughout the day. Tell the employee that this is for the purpose of analyzing staffing needs, workload, or other business issues. Most employees will “upgrade” their day-to-day activities to enhance their importance to the company, thereby providing the employer with documented proof that the employee is performing exempt work for a majority of the workday.

The employer also can ensure that even exempt employees are given adequate time for regular meal and rest breaks. Encourage employees in writing to take those breaks to promote health and clarity, and to let management know if the employee's workload prevents regular breaks. This will support an argument that breaks were available and encouraged, which may defeat a later claim of missed breaks due to excessive work or supervisory direction.

The employer also can avoid overtime hours entirely, asking employees not to work outside of the office or normal business. External methods of tracking working time may be useful as well: implement security cameras, access or parking cards and/or computer tracking to provide a basis for confirming actual hours of work. These records may serve to defeat a later overtime claim –

but note that these methods also may prove excessive overtime hours, so monitor actual activity and be aware of the potential risk!

If a misclassified employee is leaving the job, consider offering a severance package in exchange for a signed release of claims. A misclassified employee may not be aware of the potential misclassification, and if there is a legitimate dispute regarding the classification status, the employer may be able to deter future legal action by offering a “transition package” to an employee separating from employment.

**2. *Inform the employee of the misclassification, determine any damages that may be due and pay the employee for those damages.*** This approach requires a discussion with the employee to determine how many hours of overtime were worked, and whether any rest or meal periods were missed, late or shortened. Additional information can be determined by looking at computer activity, e-mail or voicemail traffic, telephone logs, security cameras, parking entries, and anecdotal information from other employees.

It is easier to pin down those details if the employer requires employees to work only in the company’s computer system and refrain from taking work home, or keeps office doors locked outside of regular business hours, or implements other external parameters on the ability to work. Consider researching these tracking details before talking to individual employees: being prepared with information about the employee’s activities will permit the employer to ask the right questions and lead the discussion with the employee, and may cut down on “manufactured” claims.

Once the possible damages have been determined, work with employment law counsel to develop written documentation (preferably a declaration under penalty of perjury) of the employee’s report. Add an additional sum to whatever the employee may reasonably be due and request that the employee sign a release of claims in exchange not only for payment of the missing amounts due, but additional consideration to support a release of wage claims. Many employees are thrilled to receive unexpected compensation and are happy to sign a release to receive not only the money they didn’t know they were entitled to be paid, but also additional sums they would not otherwise have received at all.

**3. *Correct the misclassification going forward but choose not to address potential prior liability.*** This approach corrects the problem for future reference, while accepting the business risk of a claim based upon prior classification status. Wage and hour claims carry a

minimum three-year and maximum four-year statute of limitations. As each day passes, the employee's past claim is concurrently diminished. If an employee is unaware of the possible claims, or chooses not to pursue available claims, those claims may be reduced or extinguished entirely as the employee continues his working relationship with the company.

In this circumstance, it becomes necessary for the employer to create a solid business reason for the new classification, to roll out the change without waving a "red flag" about prior violations. The "daily activity log" referenced above can assist with this transition. Once employees have logged their activities for three to four weeks, review those logs and point out to the employee that their job appears to have changed over time and a reclassification will now be necessary to fit their current activities. Altering the employee's job duties slightly may help as well; inform the employee that you need to assign other duties to him for the time being and these new duties require a reclassification to protect the employee's rights.

Employers also let employees know that you would like to ensure that they are paid appropriately for the additional efforts they are putting in, and that the only way to do so is to reclassify them and make sure they are given extra overtime pay (which is not available with an exempt classification). Tell them that management cannot consider salary increases or additional hiring until it is able to determine that more help is needed, or that employees are working more than management previously realized, and reclassification with time records is the best way to determine the amount of work actually being performed.

Another option is to explain that management wants to work on a company-wide review of staffing costs and budget, and it is necessary to reclassify employees to non-exempt status for a period of time to review actual hours worked and availability of breaks throughout the workday. Tell employees that their status will be revisited in the future, and that this is expected to be a temporary transition (and then continue with that status going forward). You also can maintain existing job titles despite changing the classification – the employee can still be a "director" or "manager" to the outside world, while maintaining time records and taking meal and rest periods throughout the workday.

It can also be helpful to make classification adjustments at the start of the calendar or fiscal year, noting that newly-implemented laws or cases have altered the landscape of available exemptions, or that budget and staffing issues require a restructuring of the current organizational chart and relevant positions. Similarly, revising the organizational chart and changing position titles, duties

or reporting relationships under new management or in a new year can provide a business reason for the change (other than admitting that the prior classification was incorrect). Starting work on a new project or contract and claiming that the customer requires a different status can be used as well, if business circumstances permit that argument.

Ultimately, if financial resources permit without bankrupting the company, it is always best to correct any prior errors, pay employees fairly, resolve any pending issues and move forward in full compliance. Wage and hour laws are implemented to protect employees' rights, and misclassified employees have been denied those rights; they are entitled to be paid fairly and should not be penalized for the employer's mistake. Nevertheless, there are a variety of ways to roll out any necessary classification changes to avoid excessive costs or maintain employee morale. Employers should seek assistance from an employment law attorney on a regular basis, to analyze exempt classifications and correct any errors, and to avoid or minimize the extraordinary liability resulting from wage and hour violations.

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