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Deductions from Salary to Recover Bonus Overpayment Renders Employees Nonexempt

Lawrence Peikes and Gregory A. Brown, Wiggin and Dana LLP

Tackling the question of whether an employer may deduct errant bonus overpayments from the base salary of exempt employees, the U.S. Court of Appeals for the Sixth Circuit held, in *Baden-Winterwood v. Life Time Fitness, Inc.*, 566 F.3d 618 (6th Cir. 2009), that actual deductions for mistaken bonus payments violate the salary-basis test and therefore vitiate the otherwise applicable overtime exemption under the Fair Labor Standards Act (FLSA).

Life Time Fitness, Inc. paid its exempt senior management staff on a salary basis with regular semi-monthly pay periods. These employees were also eligible for monthly bonus payments based on their year-to-date performance in accordance with certain corporate guidelines.

However, on January 1, 2004, Life Time Fitness altered its corporate bonus pay plan to reserve the right to reclaim advance bonus payments from an employee's base salary, if the employee's year-to-date performance dropped below a certain level. Life Time Fitness broadened its right to recoup advance bonus payments on January 1, 2005, amending the bonus pay plan so that the company could deduct the amount of such payments from an employee's base salary if the employee's performance dropped so much that the amount of the advance bonus payments exceeded the amount actually earned. Although no employees had their base salary payments reduced in 2004, Life Time Fitness reduced the base salary payments of eight employees over three pay periods in November and December of 2005.

Life Time Fitness modified its corporate bonus pay plan again on January 1, 2006, this time implementing a hold back "bank" comprised of 20 percent of employees' earned bonuses as an insurance policy against overpayment. If an employee's performance dipped sufficiently that the amount of bonus paid to the employee was greater than the amount earned, Life Time Fitness would reclaim the overpayment from the hold back bank and then, if necessary, from the employee's future base salary payments.

Following the implementation of the 2006 plan, Amy Baden-Winterwood, and several other senior management employees, sued Life Time Fitness in the U.S. District Court for the Southern District of Ohio alleging that the company improperly classified them as exempt salaried employees. According to the plaintiffs, Life Time Fitness' reduction of their pay based on "variations in the quality or quantity" of their work rendered them nonexempt under the Department of Labor's (DOL) revised salary-basis test set forth in its regulations at 29 C.F.R. § 541.602(a). Life Time Fitness countered that any salary deductions were made solely to recover overpayments of bonus pay and were unrelated to the quality or quantity of the plaintiffs' work. Both parties moved for summary judgment.

Resolving the parties' cross-motions, the district court determined as a threshold matter that because the effective date of the DOL regulations at issue was August 23, 2004, the revised regulatory salary-basis test only applied to compensation paid after that date. Under the revised regulations, there is no violation of the salary basis requirements and, therefore, no loss of the exempt status, unless there is an actual practice of improper salary deductions. Based on the revised regulations, the district court held that Life Time Fitness had improperly reduced certain plaintiffs' salary during three pay periods occurring in November and December 2005, entitling those employees, and other employees within the same job classifications, to overtime compensation.

Turning to the pre-August 23, 2004, period, the court declined to decide whether the regulatory salary-basis test retroactively superseded the Supreme Court's decision in *Auer v. Robbins*, 519 U.S.

452 (1997). The *Auer* test provides that an employee is not paid on a salary basis, and thus loses exempt status, if (i) there is an actual practice of salary deductions or (ii) an employee is compensated under a policy that clearly communicates a significant likelihood of deductions. According to the court, Life Time Fitness did not violate the salary-basis test before August 23, 2004, regardless of which standard applied. Consequently, the court dismissed the claims of ten plaintiffs in their entirety. Those ten employees appealed the district court's decision. Life Time Fitness cross-appealed.

Noting that DOL regulations do not apply retroactively, the Sixth Circuit unequivocally held that the new regulatory pronouncements applied only to the post-August 23, 2004, timeframe, and the *Auer* test controlled the pre-August 23, 2004 period. Applying *Auer*, the court rejected the plaintiffs' contention that the November and December 2005 salary deductions established an actual practice of deductions during the pre-August 23, 2004, timeframe.

Nevertheless, the court of appeals held that the district court erred in finding there was not a significant likelihood that deductions would occur during that time. Specifically, the court refuted the district court's rationale that Life Time Fitness' couching of its right to reduce employee's base salary payments in permissive (may) rather than mandatory (will) language, provided insufficient evidence that Life Time Fitness actually intended to enforce the policy. According to the court, the purposes of the FLSA would be frustrated if employers could avoid its strictures simply by phrasing their policies in permissive language.

To the contrary, the court held, the *Auer* test is satisfied whenever a policy permits deductions in pay "as a practical matter" and deductions are "more than a theoretical possibility" under the policy. Because Life Time Fitness took affirmative steps to communicate that its bonus pay plan would be enforced-and ultimately did enforce the plan-the pre-August 23, 2004, compensation plan did more than create a theoretical possibility of deductions. Thus, the court held that the company could be liable to those plaintiffs employed and subject to the compensation plan from January 1, 2004, through August 23, 2004.

The court also upheld the application of the regulatory salary-basis test to the post-August 23, 2004, period, finding no support for Life Time Fitness' argument that the reduction of guaranteed salary was permissible to recover intentionally made advance bonus overpayments and shooting down the contention that the reductions were not tied to the quality or quantity of the individual employees' work. As a result, the court affirmed the district court's holding that Life Time Fitness improperly reduced the base salary payments to certain employees during three pay periods in November and December 2005. The court also affirmed the district court's determination that only those plaintiffs who worked in the same job classifications as employees subject to the deductions were entitled to overtime compensation.

Employer Notes: *Baden-Winterwood* underscores the need to ensure bonus, commission, and similar incentive plans are properly structured so as not to jeopardize employees' exempt status under the FLSA. Notwithstanding the Sixth Circuit's recognition that only actual improper deductions will violate the salary-basis requirements of the revised DOL regulations, employers should be hypervigilant in ensuring that no deductions from guaranteed pay, such as base salary, are made that are arguably based on the "quality or quantity" of an exempt employee's work.

As *Baden-Winterwood* demonstrates, failure to do so can render both the employee whose pay was deducted and other employees in the same job classification as nonexempt under the FLSA for at least the pay period in which the improper deductions were made, thus entitling them to overtime compensation for such periods. Additionally, wage deductions may also implicate state laws, which often impose strict standards regarding deductions from employee wages.

Lawrence Peikes and Gregory A. Brown, Wiggin and Dana. You can contact Mr. Peikes at lpeikes@wiggin.com and Mr. Brown at gbrown@wiggin.com.

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