A Timely Analysis of Legal Developments

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Minnesota Supreme Court Ruling is a Reminder to Think Twice Before Taking Deductions from Wages

By David Goldstein

An employer pays its managers an annual salary and in addition provides monthly advances based on an estimate of the incentive bonus the employee appears likely to have earned by the end of the year. However, if the employee's performance declines over time so that the earned bonus ends up being less than the amounts advanced over the course of the year, it seems obvious that the employer should be able to deduct the overpayments from future paychecks.

A recent Minnesota Supreme Court decision serves as a reminder that things are rarely that simple: Minnesota employers need to be careful when taking deductions from wages. On a brighter note, the decision holds that some deductions from exempt employees are permitted under the Minnesota Fair Labor Standards Act.

The Minnesota Supreme Court recently held, in *Erdman v. Life Time Fitness, Inc.*, No. A08-1993 (Sept. 9, 2010), that deductions from exempt employees' wages to recover bonus overpayments did not alter their status as salaried employees under the Minnesota Fair Labor Standards Act (MFLSA). The court's primary holding will be helpful to Minnesota employers looking to design (or having to defend) incentive compensation programs for exempt employees that involve pay advances and adjustments. However, the decision will not help the majority of employers who are also subject to the federal Fair Labor Standards Act (FLSA).

In addition, in declining to consider whether such deductions are subject to the requirements of section 181.79 of the Minnesota Statutes, which regulates how and when employers may make paycheck deductions, the court missed an opportunity to clarify an issue that bedevils Minnesota employers.

Background of the Case

The employer in *Erdman* adopted a compensation program for its exempt managers that consisted of an annual or "base" salary with the ability to earn an annual bonus based on his or her department's performance. Although each manager's

bonus was not determined until year's end, the estimated bonus was given out in advance in monthly installments, based on year-to-date results versus year-to-date goals.

On occasion, however, this system of monthly installments led to overpayments. This would occur when a manager could not sustain his or her department's performance over the course of the year and thus failed to earn all of the bonus compensation that had already been paid out. Life Time reserved the right to reclaim such overpayments through deductions from the employee's paycheck.

In November and December 2005 Life Time made deductions from 12 managers to reclaim previously paid but ultimately unearned bonus payments. Depending on the amounts involved, the deductions were taken out of one, two, or three paychecks. The deductions from plaintiff Sarah Erdman's paychecks totaled $1,000.

Erdman subsequently instituted a class action against Life Time alleging violations of the MFLSA. In particular, Erdman argued that Life Time did not guarantee members of the class a predetermined wage for each workweek because the compensation plan allowed Life Time to make deductions from their paychecks. As a result, according to Erdman, the managers were not "salaried" for purposes of the MFLSA and, therefore, were entitled to overtime for hours worked in excess of 48 per week. Erdman further argued that Life Time's compensation scheme encouraged managers to work overtime hours to meet their department goals in order to avoid the paycheck deductions.

The employer's first argument in response to plaintiffs' claims was that the managers did, in fact, meet the criterion for salaried status.

To support its second argument, Life Time took the unusual position that it had, in fact, violated a Minnesota statute by deducting the overpayments, but argued that the violation was of section 181.79 and not the MFLSA. Therefore, Life Time argued, the plaintiffs' only remedy would be under section 181.79.

Section 181.79 (Wages Deductions for Faulty Workmanship, Loss, Theft, or Damage) provides that employers may not make deductions from wages earned by an employee to recover for property loss or "claimed indebtedness running from employee to employer" unless the employee "voluntarily authorizes the employer in writing to make the deduction" after the loss or claimed indebtedness has arisen. Damages under section 181.79 are limited to twice the amount of the deduction or credit taken.

Judicial acceptance of this argument would have limited Life Time's liability in the case at hand, but further complicate things for employers looking to recover overpayments from employees in the future.

The Trial Court Ruling

Both sides moved for summary judgment in state district court and the trial judge found for the plaintiffs, holding that Life Time's compensation scheme violated the MFLSA because the employer had classified employees as exempt from overtime when they were not actually receiving a salary. The trial court concluded that because a manager's salary could be reduced, the managers were not assured a predetermined wage for each workweek.

The trial court also found section 181.79 to be inapplicable because bonus payments cannot be considered an "indebtedness running from employee to employer."

The Court of Appeals Decision

On appeal, the Minnesota Court of Appeals reversed the trial court's finding with regard to section 181.79, holding that the statute did apply to the deductions at issue. The appellate court, however, then went on to reject Life Time's argument that section 181.79 precluded claims under the MFLSA, finding that plaintiffs were entitled to seek relief under either statute. Finally, the court of

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appeals found that there was no violation of the MFLSA, reasoning that because the managers were guaranteed a predetermined amount of pay for each workweek, they were properly classified as exempt.

The Minnesota Supreme Court's Resolution of the MFLSA Issue

In reviewing the decision of the court of appeals, the Minnesota Supreme Court first looked to the rules promulgated by the Minnesota Department of Labor and Industry to enforce the MFLSA.

Like the FLSA, the MFLSA requires that an employee be paid a "salary" in order to be considered exempt from the statute's overtime requirements. Under the Minnesota Department of Labor and Industry's rules, an employee is paid a salary if the employee, through agreement with an employer, is guaranteed a predetermined wage for each workweek." Unlike the FLSA, however, the Minnesota Rule further provides that "[a]n employee may still be salaried even if complete days absent are deducted from salary for reasons other than no work available."

After discussing the language of the statute and its implementing rule, the Minnesota Supreme Court found that Life Time's compensation program satisfied the MFLSA. The court noted that each manager was contractually guaranteed some amount in wages per year. The court found:

> This salary was predetermined, or set in advance, and Erdman earned the same equal portion of this salary for each week she worked. The same was true for other class members, whose annual salary was also established by contract. Class members earned a set amount of compensation for each week they worked — the appropriate proportion of their yearly salary — and this weekly wage did not depend on how many hours they worked. Life Time may have deducted amounts from paychecks, affecting class members' net pay, but class members' base-pay earnings remained static week to week. The deductions were based on previous bonus overpayments, and were not directly based on the number of hours worked. Moreover, year-to-date compensation for class members was never less than their year-to-date annual salary amount. We therefore conclude that Life Time guaranteed class members a predetermined weekly wage.

In reaching this result, the Minnesota Supreme Court acknowledged that the federal courts interpreted the FLSA differently but explained that this was because the federal regulations provide that an employee is paid a salary if that "employee regularly receives . . . a predetermined amount," whereas the MFLSA requires that employees be guaranteed a predetermined wage. In addition, unlike the FLSA, there is no regulation under the MFLSA regarding deductions and the effect a paycheck deduction has on an employee's exempt status.

The Applicability of Section 181.79 Remains Unresolved

Finding that its interpretation of the MFLSA was dispositive of the plaintiffs' claims, the Minnesota Supreme Court declined to consider the parties' arguments regarding section 181.79, unfortunately leaving the applicability of this statute unresolved. So for now, the only authority on this issue is a rather perfunctory determination by the court of appeals that at least the deductions at issue in this case were subject to the requirements of section 181.79.

Conclusion

As a result of this decision, employers subject only to the MFLSA are free to implement compensation systems that combine a base salary with advances without having to worry about jeopardizing employees' exempt status in the event that overpaid advances must later be recovered through deductions from future paychecks. The majority of employers, however, are also subject to the FLSA. Under the FLSA, a compensation system like the one utilized by Life Time may result in a loss of the employee's exempt

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status, creating a significant exposure for the employer. Employers with compensation systems that include taking deductions from the wages of exempt employees must carefully review those systems to ensure compliance with the FLSA.

In addition, the portion of the court of appeals' decision holding such deductions to be subject to the requirements of section 181.79 (which the Minnesota Supreme Court did not review) suggests that employers should consider structuring such compensation arrangements in a manner that will comply with this statute. Employers should not only carefully document and clearly communicate to employees how advances will work, but should consider obtaining signed agreements confirming the methodology for calculating an overpayment and authorizing the employer to deduct for overpayments.

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