

# **Startups Can Avoid Significant Liability by Heeding Wage and Hour Laws**

## **New businesses risk stiff penalties for running afoul of the federal Fair Labor Standards Act and companion state laws – especially New York’s**

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Launching a new company is exciting, but the human capital component – the workforce – can be stressful because founders must contend with a complex array of employment laws. One of the major pitfalls I see when advising early- and mid-stage startups on employment issues is a complete lack of attention to federal and state wage and hour laws. Companies are often so focused on developing a concept, fundraising and trying to get their business off the ground that they overlook this area of business regulation – an oversight that can prove terribly costly and ultimately may deter investors.

While most states have their own wage and hour laws in addition to the federal Fair Labor Standards Act, New York’s are particularly strict and penalties for noncompliance are severe. Many startups simply assume that if they do what other startups do – classify workers as independent contractors, pay people primarily in equity grants, or pay out salaries to every employee – they will be in the clear. That mistake can be perilous and trigger litigation with potentially steep settlement costs. Individual owners may also be found liable for wage law violations along with the company.

To avoid the expense and distraction of litigation over wage and hour issues, it is wise to consult with human resource experts and employment counsel before making the first hire. Below is a summary of common wage and hour issues faced by New York-based startups.

### **Misclassifying Employees as Exempt**

A common mistake startups make is failing to account for an employee’s status as either “exempt” or “non-exempt.” Most tend to simply pay each employee a salary and assume there’s nothing more to worry about. However, under federal and New York law, employers must document the hours a “non-exempt” employee works and pay the employee at least the minimum wage for each hour worked (currently \$15 per hour in New York) and 1.5 times their regular rate of pay for all time worked over 40 hours in a work week. By contrast, “exempt” employees receive a fixed salary for all hours worked, no matter how many hours they work in a given work week – and the company has no need to track the employee’s hours or worry about overtime pay. Misclassifying employees as exempt can be a costly mistake, as the employer can potentially be on the hook for paying the employees for unpaid overtime,

liquidated damages (equal to 100% of the unpaid overtime wages), and attorneys' fees. Accordingly, startups should carefully evaluate whether they have properly classified their employees.

To be classified as exempt, an employee must satisfy (1) a salary test (with some exceptions, as discussed below) and (2) a duties test. To satisfy the salary test in New York City, an employee must earn a salary (defined as a predetermined amount paid each pay period that does not vary based on the quality or quantity of the work performed) of at least \$1,125 *per week* for executive/managerial employees and administrative employees or at least \$684 *per week* for professional and computer professional employees.

If the salary threshold is met, companies must also consider the duties the employee performs to determine whether the duties test is satisfied. There are several types of exempt employees, the most common being: (1) executive/managerial employees; (2) administrative employees; (3) professional employees; (4) computer professional employees; and (5) outside sales employees.

### **1. Executive/Managerial Employees**

To satisfy the executive/managerial employee exemption, the employee must have the following as their primary duties:

- Management of the business or of a customarily recognized department or subdivision thereof;
- Customarily and regularly directs the work of two or more other employees;
- Has authority to hire or fire other employees or give suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status of other employees and such suggestions and recommendations are given particular weight; and
- Customarily and regularly exercises discretionary powers and use independent judgment.

### **2. Administrative Employees**

To satisfy the administrative employee exemption, the employee must have the following as their primary duties:

- Performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers; and
- Such work includes the exercise of discretion and independent judgment with respect to matters of significance.

The phrase “directly related to the management or general business operations” refers to the type of work performed by the employee. Specifically, the employee must perform work directly related to assisting with the running or servicing of the business, as distinguished, for example, from working on a production line or selling a product in a retail or service establishment.

Regarding the “exercise of discretion and independent judgment,” factors to consider are: whether the employee has authority to formulate, affect, interpret, or implement management policies or operating practices; whether the employee carries out major assignments in conducting the operations of the business; whether the employee has authority to commit the employer in matters that have significant financial impact; whether the employee has authority to waive or deviate from established policies and procedures without prior approval; whether the employee has authority to negotiate and bind the company on significant matters; whether the employee provides consultation or expert advice to management; whether the employee is involved in planning long- or short-term business objectives; whether the employee investigates and resolves matters of significance on behalf of management; and whether the employee represents the company in handling complaints, arbitrating disputes or resolving grievances.

While the phrase “exercise of discretion and independent judgment” implies that the employee has the authority to make an independent choice, free from immediate direction or supervision, employees can exercise discretion and independent judgment even if their decisions or recommendations are reviewed by management. Thus, the term “discretion and independent judgment” does not require that the decisions made by an employee have a finality that goes with unlimited authority and a complete absence of review.

### **3. Professional Employees**

Professional employees need only be paid \$684 per week to meet the salary threshold. Additionally, employers may pay up to 10% of this salary threshold through non-salary, non-discretionary income, such as commissions or bonuses.

To satisfy duties test of the professional employee exemption, the employee’s primary duties must consist of the performance of work that:

- Requires knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction and study, as distinguished from (i) a general academic education, (ii) an apprenticeship, or (iii) training in the performance of routine mental, manual or physical processes; or

- Is original and creative in a recognized field of artistic endeavor and produces a result that depends primarily on the invention, imagination or talent of the employee; and

Additionally, the employee's work must:

- Require the consistent exercise of discretion and judgment in its performance;
- Be predominantly intellectual and varied in character (as opposed to routine mental, manual, mechanical or physical work); and
- Be of such a character that the output produced or the result accomplished cannot be standardized in relation to a given period of time.

#### **4. Computer Professional Employees**

Computer professional employees need only be paid \$684 per week to meet the salary threshold (alternatively, such employees can be paid at least \$27.63 per hour). Additionally, employers may pay up to 10% of this threshold through non-salary, non-discretionary income, such as commissions or bonuses.

To satisfy duties test of the computer professional employee exemption, the employee's primary duties must consist of:

- The consistent exercise of discretion and judgment in its performance;
- The application of systems analysis techniques and procedures, including consulting with users, to determine hardware, software or system functional specifications;
- The design, development, documentation, analysis, creation, testing or modification of computer systems or programs, including prototypes, based on and related to user or system design specifications;
- The design, documentation, testing, creation or modification of computer programs related to machine operating systems; or
- A combination of the above duties, the performance of which requires the same level of skills.

The computer professional exemption does not include employees engaged in the manufacture or repair of computer hardware and related equipment. Additionally, employees whose work is highly dependent upon, or facilitated by, the use of computers and computer software programs (e.g., engineers, drafters and others skilled in computer-aided design software), but who are not primarily engaged in computer

systems analysis and programming or other similarly skilled computer-related occupations, are also not exempt under this exemption.

## **5. Outside Sales Employees**

To be exempt under the outside sales employee exemption, there is no salary test. However, the employee must be customarily and predominantly engaged away from the company premises and not at any fixed site or location for the purpose of: (i) making sales; or (ii) selling and delivering articles or goods; or (iii) obtaining orders or contracts for service or for the use of facilities. In order to satisfy this exemption, the employee must spend at least 50% of time away from the employer's premises and the employee must earn a commission or similar payment for the work performed.

Additionally, the outside salesperson must have a written agreement establishing the terms of their compensation.

## **Misclassifying Employees as Independent Contractors**

Another common mistake that startups make is treating new hires as independent contractors and paying individuals on an IRS Form 1099 basis. In New York, the test for whether an individual is properly classified as an independent contractor is a tough one. Most individuals will likely be considered employees and therefore should be paid wages on an IRS Form W2 basis. It is crucial that startups properly classify individuals as employees and contractors before they perform any work because misclassification of a true employee as a contractor can result in liability for unpaid wages, liquidated damages, and attorneys' fees. Additionally, the company can be on the hook for back taxes, interest, and penalties due to a failure to pay payroll taxes.

In New York, an *employer-employee* relationship likely exists if the company:

- Chooses when, where, and how the individual performs services.
- Provides facilities, equipment, tools, and supplies.
- Directly supervises the services the individual provides.
- Sets the hours of work.
- Requires exclusive services (*i.e.* the individual cannot work for competitors while working for the company).
- Sets the rate of pay.

- Requires attendance at meetings and/or training sessions.
- Asks for oral or written reports.
- Reserves the right to review and approve the work product.
- Evaluates job performance.
- Requires prior permission for absences.
- Has the right to hire and fire the individual.

In contrast, an *independent contractor* relationship might exist if the individual is free from supervision, direction, and control in the performance of their duties. Typically, independent contractors are in business for themselves and offer their services to the general public, such as a plumber you hire on one occasion to fix a leaky sink versus a maintenance employee you hire to handle all maintenance issues that arise in your office.

Key factors to consider when evaluating whether an individual is truly an independent contractor include whether the person:

- Has an established business.
- Advertises in electronic and/or print media.
- Uses business cards, stationery, and billheads.
- Carries insurance.
- Keeps a place of business and invests in facilities, equipment, and supplies.
- Pays their own expenses.
- Assumes risk for profit or loss.
- Sets their own schedule.
- Sets or negotiates their own pay rate.
- Offers services to other businesses (competitive or non-competitive).
- Is free to refuse work offers.
- May choose to hire help.

### **Failing to Provide Employees with Proper Wage Documentation**

Finally, a frequent mistake startups make is failing to provide employees with proper wage documentation. Under New York law, employers must provide all employees with a wage notice (commonly known as a rate of pay form) at the time of hire and every time the employee's rate of pay changes. Employers are also required to provide employees with a wage statement (commonly known as

a paystub) with each paycheck. Each of these documents must contain all of the information required under the law. Failure to comply with the exact requirements of the law can result in up to \$10,000 in penalties per employee – \$5,000 for the rate of pay violation and \$5,000 for the paystub violation.

Rate of pay forms must be provided to employees in English and the employee's primary language if not English. They must be signed by a company representative and the employee and must include the following information:

- The name of the employer;
- Any "doing business as" names used by the employer;
- The physical address of the employer's main office or principal place of business, and a mailing address if different;
- The telephone number of the employer
- The rate or rates of pay and basis thereof, whether paid by the hour, shift, day, week, salary, piece, commission, or other;
- Allowances (also called "credits"), if any, claimed as part of the minimum wage; and
- The regular pay day designated by the employer.

With respect to the paystub requirement, the company must provide employees with a detailed paystub with each paycheck (or make available a detailed paystub if wages are paid via direct deposit).

Each paystub must include:

- The dates of work covered by that payment of wages;
- The name of the employee;
- The name of the employer;
- The address and phone number of the employer;
- The rate or rates of pay and basis thereof, whether paid by the hour, shift, day, week, salary, piece, commission, or other;
- Any overtime rate of pay if applicable;
- The regular hours worked;
- The amount of sick leave provided;
- The overtime hours worked if applicable;
- The gross wages;

- Any deductions/withholdings;
- Allowances/credits, if any, claimed as part of the minimum wage; and
- The net wages.

Additionally, under New York City's sick leave law, every paystub must include (1) the amount of sick time accrued and used during a pay period and (2) an employee's total balance of accrued sick time. If the company offers PTO that can be used for sick leave reasons, the paystub should include this information for an employee's accrued, used, and available PTO.

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The above is only an overview of common wage and hour issues New York startups encounter. In addition to consulting with general or business counsel when starting a business, founders should speak with experienced labor and employment counsel to ensure compliance with applicable wage and hour laws.

*To discuss wage and hour issues, and to avoid the pitfalls many early-stage companies encounter, please reach out to Matthew Berger at 601.646.7658 or [mberger@foxrothschild.com](mailto:mberger@foxrothschild.com).*