



Recent Court Case Highlights Limitations Of An “Unlimited” Vacation Policy In California

Insights

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A California state court just created a controversy for those employers in the state that provide unlimited vacation policies for their exempt workers, holding that in some such instances you may need to pay out vacation time upon separation. While, contrary to common belief, you are not legally required to provide paid or unpaid vacation to California workers, you should beware of the specific and often complex California laws concerning vacation benefits if you do provide paid vacation. That’s because, with the limited exception of “unlimited” vacation policies, once earned, paid vacation constitutes a form of wages and must be paid out on separation if not used.

In recent years, many employers have been transitioning to “unlimited” vacation policies, particularly for exempt employees who are rarely unplugged from the workplace. Employees subject to such policies may generally take as much vacation as they would like, typically subject to productivity requirements and business needs. Because vacation does not vest under this type of policy, it need not be paid out on separation.

In a case of first impression, a California Court of Appeal just held that Labor Code Section 227.3, which requires the pay out of vacation on separation, applies to an employer’s unwritten “unlimited” vacation policy. The court recognized, however, it “by no means hold that all unlimited paid time off policies give rise to an obligation to pay ‘unused’ vacation when an employee leaves.”

The Facts

In *McPherson v. EF Intercultural Foundation, Inc.*, the employer had a written vacation policy in its employee handbook that applied to hourly employees but did not apply to the three plaintiffs that were exempt managers. These managers were verbally told they could take time off with pay but did not accrue vacation days. They did not use the company’s online system to request time off or track the number of days taken. Instead, they were required to notify their supervisors before taking time off and time off during certain busy periods was “strongly discouraged.”

None of the three plaintiffs, who ended their employment with the company for different reasons, were paid out accrued, unused vacation on separation. They filed a claim alleging violation of Labor Code Section 227.3 and seeking waiting time penalties under Labor Code Section 203, among other claims. The employer defended the claims on the basis that it had an “unlimited” vacation policy, thus the aggrieved workers were not entitled to any payout under Labor Code Section 227.3.

The Decision

After a bifurcated bench trial, the trial court concluded that the plaintiffs' ability to take vacation was not truly "unlimited" and therefore accrued, unused vacation was owed. The court found that "vacation time vests under a policy where vacation time is provided, even if the precise amount is not expressly defined by the employer in statements to employees."

The court based its holding on "law and equity under section 227.3," finding as a legal determination the evidence demonstrated 20 days' annual vacation was available to plaintiffs under the company's policy, and under principles of equity and fairness, the court stated it was "attempting to provide plaintiffs with adequate compensation for unused vacation time, without over-compensation, in circumstances where the amount of vacation time available was not expressly defined."

On appeal, the Court of Appeal held Section 227.3 applied to the Company's "purported 'unlimited' paid time off policy *based on the particular facts of this case*." The court noted the company did not have a formal written "unlimited" vacation policy, did not inform plaintiffs they were entitled to "unlimited" vacation, and did not offer "unlimited" vacation in practice.

Rather, the court held the policy had an "implied limit" of two to four weeks per year and plaintiffs generally could not (and did not) take more than this amount. Based on this holding, the court awarded the former workers vacation pay damages. As a silver lining, the court did not award waiting time penalties because it found the company had a "reasonable, good faith believe that vacation wages were not owed."

Vacation Policy Takeaways For Employers

Though there is no obligation to provide employees paid time off or paid vacation, if employers choose to do so, there are some important points to keep in mind.

Standard Vacation Policies

"Use it or lose it" policies are not allowed in California, but you may impose a waiting period before vacation accrual begins and a reasonable cap on vacation accrual, as well as require or prohibit the use of vacation during certain times. You should carefully draft standard vacation policies and include clearly written terms regarding when employees start to accrue, the accrual rate, caps on accrual, your right to designate or deny vacation, accrual during leaves and other time off (e.g., the timely example of a furlough), and payout of unused vacation on separation.

Unlimited Vacation Policies

As noted, the court did not hold Section 227.3 necessarily applies to "truly unlimited time off policies." In this regard, the court offered suggestions for an enforceable written unlimited vacation policy, including that the policy:

1. Be in writing;
2. Clearly provide that employees' ability to take paid time off is not a form of additional wages for services performed, but perhaps part of the employer's promise to provide a flexible work

- services performed, but perhaps part of the employer's promise to provide a flexible work schedule – including employees' ability to decide when and how much time to take off;
3. Spell out the rights and obligations of both employee and employer and the consequences of failing to schedule time off;
 4. Allow sufficient opportunity for employees to take time off, or work fewer hours in lieu of taking time off; and
 5. Is administered fairly so that it neither becomes a de facto 'use it or lose it policy' nor results in inequities, such as where one employees works many hours, taking minimal time off, and another workers fewer hours, and takes more time off.

Still, these criteria are only examples in dicta of an otherwise unfavorable decision for employers and should be applied with caution.

Other Points Of Interest

The 58-page opinion contained some other interesting notes for employers:

1. **Invalidated Release Agreement.** One of the three plaintiffs signed a separation agreement, wherein the employer paid three months of severance pay. The court invalidated the release citing Labor Code Section 206.5, which prohibits an employer from requiring an employee to release a claim for wages that are due and unpaid unless it has paid those wages. Though there exists a limited exception that wages are not considered due when an employer and employee have a bona fide dispute as to whether the wages are owed, the court found that no such bona fide dispute existed because neither the employer or employee were aware that vacation was owed at the time the severance was negotiated. This case highlights that a release agreement may not necessarily preempt future wage claims where no "bona fide dispute" exists.
2. **Employer's Failure to Plead Offset Led to the Waiver of this Affirmative Defense.** The employer argued that the severance payment should be used to offset any owed vacation. However, the trial court disagreed on the basis that the severance paid for the release of other claims. The Court of Appeal went further and barred the employer from arguing offset because the employer had not pled offset as an affirmative defense. This is a good reminder to carefully plead and include all affirmative defenses that may apply in responding to a Complaint.
3. **Out-of-State Employee Not Entitled to Vacation Payout.** Though the employer did not get many lucky breaks in this case, the Court of Appeal did reverse the vacation payout for any vacation awarded from the date one of the plaintiffs moved out of California forward. The court made clear that California protections will apply in certain situations, such as the payment of overtime, when a non-resident, non-exempt employee works at least one full day in the State of California but does not apply to vacation earned by a non-resident employee, who also performed work outside the State of California. Though the court was conservative extending California's wage and hour laws with regard to vacation, this is a good reminder of the other protections that may exist in California, even for non-resident employees performing work in California (there is additional pending case law on this issue as well).

Conclusion

California is full of landmines for employers and employers must stay vigilant with compliance. This case illustrates that a compliant written policy could potentially save the day – and a lawsuit. For questions on adopting best practices in your organization, contact the authors, your Fisher Phillips attorney, or any attorney in [our California offices](#).

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Nicole Kamm
Partner
818.230.4253
[Email](#)



Hannah Sweiss
Partner
818.230.4255
[Email](#)

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