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New Judicial Guidance Addresses No-Accrual Vacation Policies Under California Law

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Employers increasingly offer a fringe benefit that many employees find attractive: unlimited, but unaccrued, paid vacation or time off ("PTO"). Under an unlimited, no-accrual PTO policy, employers do not grant any specific number of PTO days, and employees do not accrue PTO balances (either for future use or for cash-out at the time of termination). Instead, employees may take as much paid time off as they like, provided they meet the requirements of their jobs. An unlimited, no-accrual PTO policy should not be governed by California Labor Code section 227.3, which generally prohibits forfeiture of accrued vacation and requires that it be paid out at the time of termination.[1]

A panel of the California Court of Appeal recently issued the state's first published opinion addressing the legality of this kind of policy. Although the court in *McPherson v. EF Intercultural Foundation, Inc.*[2] held that the particular policy at issue was not a no-accrual PTO policy—and therefore was subject to California's vacation anti-forfeiture rules—it confirmed that an unlimited, no-accrual PTO policy *can* be lawful under California law if it is properly designed, communicated, and applied.

The decision also explained that Labor Code section 227.3 did not apply to a non-resident who periodically worked in California, but lived and paid taxes in another state.

All California employers with unlimited, no-accrual PTO policies would be well advised to review their policies and practices in light of the decision.

SUMMARY OF DECISION

In *McPherson*, the plaintiffs claimed they were owed vacation pay upon the termination of their employment. The defendant countered that because the plaintiffs were granted "unlimited" vacation; no vacation was accrued or owed. The trial court ruled against the defendant, holding that it did not really have an "unlimited" policy because it had no written policy or agreement to that effect, the plaintiffs actually took less vacation than many of the defendant's other managers, and the defendant's employee handbook provided limited, accrued vacation to other exempt employees.[3] To calculate damages, the court then assumed each plaintiff accrued annually the largest number of vacation days granted to any one plaintiff (four weeks per year).[4] In rejecting the defendant's contention that the policy actually was an unlimited, no-accrual PTO policy, the trial court used sweeping language that left some observers concerned about the validity of such policies generally.[5]

The Court of Appeal upheld the trial court's finding that the defendant's policy was not an unlimited, no-accrual PTO policy, and instead was an accrual vacation policy, and that the plaintiffs were owed vacation pay.

First, the court determined that, in practice, the defendant placed a *de facto* cap on the amount of time off available to the plaintiffs. The court inferred the existence of an "implied cap" because the plaintiffs "took about two weeks of vacation each year on average ... [and] never sought or received more than four weeks,"—about the same as a traditional policy.[6] The court also noted that "plaintiffs' schedules precluded them from taking advantage of [the] purported unlimited time off policy" because plaintiffs "worked more than 100 hours a week, seven days a week, up to 18 hours per day" during their "peak season," and there was "no evidence they took extended vacation or substantially reduced their hours [outside of] that time."[7] Based on that evidence, the court concluded "the record simply does not show plaintiffs reaped the benefits that ... unlimited time off policies [should] provide to employees."[8]

Second, no written policy memorialized the terms of the purported "unlimited" policy, and the defendant never told the plaintiffs they "could take as much vacation as they wanted."[9] The court held that if the defendant "intended to limit plaintiffs' ability to earn vacation pay or treat their paid time off as something other than deferred wages [that must be paid at termination], its 'unlimited' policy had to be express and clear."[10]

In affirming the trial court's decision, the Court of Appeal nevertheless made clear that an unlimited, no-accrual PTO policy *is* permissible under California law. The court noted that PTO is a matter of contract between the employee and the employer—the law does not require an employer to provide PTO—and that "[e]mployees and employers are free to contract for unlimited paid vacation, consistent with the Labor Code and governing case law."[11] To pass legal muster, however, the court wrote that an unlimited, no-accrual PTO policy likely would need to:

1. "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 schedule—including the employees' ability to decide when and how much time to take off";

2. "spell[] out the rights and obligations of both employee and employer and the consequences of failing to schedule time off";

3. "in practice allow[] sufficient opportunity for employees to take time off, or work fewer hours in lieu of taking time off"; and

4. "[be] administered fairly so that it neither becomes a *de facto* 'use it or lose it' policy nor results in inequities, such as where one employee works many hours, taking minimal time off, and another works fewer hours and takes more time off."[12]

Separately, the court held that Labor Code section 227.3 did not apply to one of the plaintiffs because he only periodically worked in California, and lived and paid taxes in another state. This aspect of the decision further defines the extent to which California's Labor Code applies extraterritorially. The California Supreme Court may soon provide further guidance on that issue when it decides three cases scheduled for oral argument this month, *Ward v. United Airlines, Inc.,*[13] *Oman v. Delta Airlines, Inc.*,[14] and *Vidrio v. United Airlines, Inc.*[15]

KEY TAKEAWAY FOR EMPLOYERS

All employers who either have already implemented or are considering an unlimited, no-accrual PTO policy should evaluate their adherence to the four factors that the court enumerated as indicative of a lawful, no-accrual policy.

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1 *Suastez v. Plastic Dress-Up Co.*, 31 Cal. 3d 774 (1982).

2 No. B290869, 2020 Cal. App. LEXIS 267 (April 1, 2020).

3 *Id.* at *10.

4 *Id*. at *19-21.

5 *Id*.

6 *Id*. at *27.

7 *Id.* at *27-30.

8 *Id*., at *30.

9 *Id*. at *32.

10 *Id*. at *33.

11 *Id*. at *2.

12 *Id*. at *36-37.

13 No. S248702.

14 No. S248726.

15 No. S248702.