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# california court of appeals severely limits application of administrative exemption from overtime

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*MSK Client Alert*

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On remand from the California Supreme Court, and contrary to federal court decisions, a divided panel of the California Court of Appeal in *Harris v. Superior Court* held that insurance claims adjusters employed by Liberty Mutual Insurance Company and Golden Eagle Insurance Corporation were not exempt from the payment of overtime. The companies argued that the adjusters qualified for the administrative employee exemption from overtime.

The Court of Appeal originally ruled in favor of the adjusters. However, on December 28, 2011, the California Supreme Court unanimously reversed that ruling, holding that the Court of Appeal erred in focusing so heavily on the "administrative/production dichotomy" to the apparent exclusion of the applicable Wage Order test for the exemption. In doing so, the Supreme Court cited federal court decisions and federal regulations suggesting that the administrative employee exemption might well apply to certain employees, such as claims adjusters, involved in servicing the employer's business. The Supreme Court directed the Court of Appeal to revisit whether the claims adjusters at issue were entitled to overtime pay using "the appropriate legal standard."

In its reconsideration of the case, the Court of Appeal claimed that it was following the Supreme Court's guidance by not focusing on the adjusters' production "role," but instead focusing on the adjusters' "duties." However, this looks like a distinction without a difference since the Court of Appeal still viewed the adjusters' duties as "production" duties in an insurance company context and hence non-exempt.

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The Court of Appeal noted that in order for an employee to be subject to the administrative exemption under the applicable California Wage Order, he or she must be primarily engaged in work that qualitatively is "directly related to management policies or general business operations." Acknowledging that the federal regulations explanation of "directly related" is not entirely clear, the Court of Appeal concluded that "only duties performed at the level of policy or general operations can satisfy the qualitative component of the 'directly related' requirement. In contrast, work duties that merely carry out the particular, day-to-day operations of the business are production, not administrative, work."

According to the Court of Appeal, adjusting insurance claims is just carrying out the day to day "production" work of an insurance company and does not involve advising management on policies or general business operations, much less formulating such policies or operational strategies. Accordingly, the Court of Appeals majority concluded that the adjusters did not qualify for the administrative exemption and were entitled to overtime compensation.

Justice Frances Rothschild dissented from part of the majority's decision, stating that the administrative/production worker dichotomy is only an analytical tool but not a definitive test. Given this decision's severe limitation of the administrative exemption, another review by the California Supreme Court would not be surprising.

However, if this Court of Appeal decision stands, it conflicts with a line of federal court decisions that have found claims adjusters to be exempt administrative employees under the federal Fair Labor Standards Act ("FLSA"). This decision also will impact many California employers outside of the insurance industry who have been treating employees who do not supervise others, but who perform important tasks involving analysis, judgment and discretion, as exempt from overtime. The overtime status of those employees is now in doubt, since this decision limits the administrative exemption solely to those few employees whose primary work task involves the formulation of company policies or general operations strategy.

In California, overtime claims can reach back up to four years from the date a court complaint is filed, and are often brought on a class action basis seeking back pay and statutory penalties. We expect more such class actions after this decision. Employers should carefully scrutinize the overtime status of their California employees, especially those classified as exempt under the administrative exemption.

### Ask MSK

#### **Q: What is the "administrative/productive dichotomy" test?**

A: When the FLSA was enacted, the American economy was fueled by manufacturing and it was clear that production employees were intended to be paid hourly and to earn overtime, while certain "white collar" employees were to be treated as exempt. Therefore, with respect to the administrative exemption, the FLSA regulations drew a distinction between employees whose primary duty is "administering the business affairs of the enterprise" (exempt employees) and those whose primary duty is "producing the commodity or commodities" produced and marketed by the employer (non-exempt employees). Both federal and California courts have adopted this "administrative/production dichotomy," but have struggled with how it applies in non-



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manufacturing environments. The *Harris* decision applies this test to narrowly limit the administrative exemption to employees who formulate or implement policies on a company-wide basis. This decision also sets up a conflict with federal decisions which do not apply the test so rigidly. Unfortunately, in the wage and hour arena state law may be more protective of employees than federal law, e.g., imposing a higher minimum wage and narrower overtime exemptions.

**Q: Does this decision impact employees who are classified as exempt under other overtime exemptions?**

A: Probably not. For example, the other common exemptions – “executive,” “professional,” “computer professional,” “retail sales,” “outside sales” and “motor carrier” –do not rely upon the “administrative/production dichotomy.”

**Q: Is an employee exempt if she does some high level work “directly related to” policy or general operations?**

A: Probably not. While the FLSA merely requires that exempt work be the employee's primary duty, California imposes a more rigid, quantitative test which requires that at least 51% of the employee's time be spent performing exempt work.

**Q: Does this decision primarily impact the insurance industry?**

A: No, it impacts all California employers who classify employees as exempt under the administrative overtime exemption. This decision's significant narrowing of that exemption may necessitate consultation with a legal expert concerning the overtime status of particular employees.

**Q: Is the California Supreme Court likely to get re-involved in this matter?**

A: Since this decision contradicts many federal court cases and was a 2-1 split decision after remand by the California Supreme Court, that court revisiting this case would not be surprising. However, unless that review occurs, this decision is in effect and employers should heed it.