

# Management Alert

## California Appellate Court Significantly Limits Administrative Exemption

On August 16, 2007, the California Court of Appeal issued its decision in *Harris v. Superior Court*, which significantly limits the scope of the administrative exemption under California law. This class action involves four consolidated actions against insurance companies. The employees, all claims adjusters, alleged that the insurance companies improperly classified them as exempt from the overtime compensation requirements of California law. The defendants insurance companies, contended the adjusters were properly classified as exempt pursuant to the administrative exemption contained in the California Industrial Welfare Commission's Wage Order 4 (Cal. Code of Regs., tit. 8, § 11040).

### The Case and Decision

In *Harris*, the court considered the parameters of a concept dubbed the "administrative/production worker dichotomy." This dichotomy, based on FLSA regulations stating that employees performing production work do not qualify for the administrative exemption, explores the

extent to which employees perform work related to the general operations of the business, an initial requirement of the administrative exemption. The dichotomy is thus a short-hand analytical tool to determine whether certain types of work qualify for the administrative exemption.

In applying the dichotomy, the *Harris* court focused on only one element of the administrative exemption—whether the claims adjusters perform work that is "directly related to management policies or general business operations"—and did not address any other element.<sup>1</sup> The court reasoned that the requirement that the work be "directly related to management policies or general business operations" of an employer encompasses two sub-requirements: (1) the work must be of a particular type (administrative, as compared to production work) and (2) the work must be of substantial importance to the management or operation of the business. The court then broadly concluded that "only work performed at the level of *policy or general operations* [emphasis in original] can qualify as 'directly related to management

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<sup>1</sup> In relevant part, the administrative exemption applies to any employee whose duties and responsibilities involve the performance of office or non-manual work directly related to management policies or general business operations of his employer or his employer's customers; who customarily and regularly exercises discretion and independent judgment; and who regularly and directly assists a proprietor, or another employee who is employed in a bona fide executive or administrative capacity (as such terms are defined for purposes of this section), or who performs, under only general supervision, work along specialized or technical lines requiring special training, experience, or knowledge, or who executes, under only general supervision, special assignments and tasks, and who is primarily engaged in duties which meet the test for the exemption.

policies or general business operations.” The court further stated: “work that merely carries out the particular, day-to-day operations of the business is production, not administrative, work. That is the administrative/production worker dichotomy, properly understood.” The court did not explain the difference between “general business operations” and “day-to-day business operations.”

Following these broad conclusions, the court applied the administrative/production dichotomy to the claims adjusters at issue. The court reasoned that the adjusters were primarily engaged in work that falls on the production side of the dichotomy, and were thus non-exempt, because they investigate and estimate claims, make coverage determinations, set reserves, negotiate settlements, make settlement recommendations for claims beyond their authority, identify potential fraud and “so forth.” This, the court determined, is “part of the day-to-day operation” of the defendants’ business, not part of its “general business operations,” and therefore was non-exempt work.

This ruling rejected arguments premised on substantial case authority. First, the insurance companies argued that their claims adjusters “serviced” the business and therefore were exempt. The court rejected the argument on the ground that these duties were not “carried on at the level of policy or general operations.” The companies next argued that the claims adjusters clearly did not produce product and therefore were not production employees. The court rejected that argument as well, declaring that “. . . producing the employer’s product is not a necessary condition for doing production, as opposed to administrative, work.” Finally, the court rejected the companies’ argument that finding “claims adjusters” non-exempt under California law would contravene a federal regulation (29 C.F.R. § 541.205(c)(5)) stating that “claim agents and adjusters” are exempt administrative employees. Even though California’s 2000 Wage Order

expressly incorporates the federal regulation, the court declined to follow numerous federal cases holding that adjusters are exempt and that the “administrative/production” dichotomy does not lead to a finding that adjusters are production workers. The court noted that the regulation merely states that “*many persons* [emphasis in original] employed as . . . claim agents and adjusters” do work that meets the requirement, while the claims adjusters at issue do not.

### How the Court Diverged from Mainstream Analysis

The *Harris* court departed significantly from traditional analysis of the administrative exemption. In attempting to apply the administrative/production dichotomy, the court became ensnared in factual quandaries about how a business works. The court supposed an undefined distinction between “general business operations” and a business’ “day-to-day activities,” concluding that as long as an employee is involved in the latter (whatever it may cover), the employee must be involved in “production,” and therefore necessarily cannot qualify for the administrative exemption, regardless of the employee’s level of judgment, discretion and decision making. The court disregarded entirely the well-recognized principle that employees servicing business operations are administrative employees—some of whom are exempt, some of whom may not be, the result hinging primarily on the level of the employee’s discretion and independent judgment.

The court’s construction of the administrative/production dichotomy – deciding if you are not an *exempt* administrative employee then you must be a “production” employee ineligible for the administrative exemption—produces inexplicable results when applied to administrative employees who are not exempt. The reason why such employees are not exempt, even though

they are administrative, is that they do not satisfy one or more of the other elements of the exemption.

For example, a Chief Financial Officer clearly is an administrative employee who does not produce goods or services. Her secretary would also be performing an administrative, not production, function. That secretary may be non-exempt because he does not necessarily exercise the independent judgment and discretion the administrative exemption requires. This fact, however, does not lead to the court's suggestion—that the secretary is somehow a *production* employee. Yet, the court, apparently adopting the logic that any non-exempt employee must fall on the production side, held that “producing the employer's product is not a necessary condition for doing production . . . work.” The court might have been trying to ensure that non-production employees such as secretaries are not misclassified as exempt administrative employees. But any fair application of the full definition of the administrative exemption would yield that result. The court unnecessarily announced a new principle at odds with the overwhelming weight of case and regulatory authority, and one that almost certainly will undermine the administrative exemption.

The *Harris* court's reasoning, if followed, would dramatically narrow the scope of the administrative exemption. After all, most employees traditionally regarded as well within the scope of the administrative exemption (human resources professionals, purchasing managers, tax consultants) are involved in day-to-day business operations. *Harris* magnifies the risk that these employees could be labeled non-exempt simply on the basis that they are, by the court's reasoning, “production” employees.

## What *Harris* Means for California Employers

*Harris* will likely be appealed to the California Supreme Court. If review is granted, the Court of Appeal's decision should be vacated. If the court's reasoning remains undisturbed, however, employers must proceed with particularly great caution when they apply the administrative exemption. In particular, employers should do the following:

- Rely on the administrative exemption only as a last resort: use other available exemptions (executive, professional, sales, etc.) wherever possible.
- Carefully review the job descriptions and functions of employees classified as administrative-exempt and, to the extent possible, ensure that they are not charged primarily with tasks that relate to carrying out the “day-to-day” business of the employer, but instead to higher-level management policy and operations. To borrow an example from *Harris*, adjusting insurance claims may be non-exempt production work under California law, but serving on a committee that shapes the company's overall policies and procedures regarding the adjustment of claims might be exempt work involving “management policies” or “general operations.”
- Closely monitor working hours of administrative-exempt employees to keep them below 8 hours per day and 40 hours per week, and confirm that rest and meal periods are taken. Document hours actually worked.

*If you have any questions concerning this Management Alert, please contact the Seyfarth Shaw LLP attorney with whom you work or any labor & employment attorney on our website at [www.seyfarth.com](http://www.seyfarth.com).*

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