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Management Alert

California Court of Appeal Significantly Narrows Administrative Exemption

On July 23, 2012, in *Harris v. Superior Court (Liberty Mutual Ins. Co.)*, a case that the California Supreme Court previously had reversed and remanded, the California Court of Appeal stuck by its prior conclusion and held that insurance claims adjusters do not qualify for the administrative exemption from overtime pay requirements. The Court of Appeal based its decision on a rationale that the adjusters are production employees who do not make general policy for their employer. This holding, if not reversed by the Supreme Court in a second review, could dramatically reduce the scope of the administrative exemption in California by limiting it to those employees whose primary duties involve setting company policy or running general business operations.

Case Background

Liberty Mutual claims adjusters filed a class action claiming that Liberty Mutual had misclassified them as exempt employees and thereby unlawfully denied them premium pay for overtime hours. After the trial court granted class certification, the claims adjusters moved for summary adjudication to dismiss Liberty Mutual's affirmative defense that they qualified for the administrative exemption. The trial court denied the claims adjusters' motion, but invited the parties to appeal the decision.

The Court of Appeal reversed, ordering the trial court to grant the claims adjusters' summary judgment motion dismissing the employer's exemption defense. The Court of Appeal applied the "administrative/production worker dichotomy" test set forth in two *Bell v. Farmers Insurance Exchange* cases—(collectively "*Bell*")—and found that, because claims adjusters did not perform administrative work, they could not qualify for the administrative exemption. The California Supreme Court granted review of the decision.

On December 29, 2011, the Supreme Court reversed the Court of Appeal's decision, concluding that it had erred in relying on *Bell* because *Bell's* holding was limited to the facts of that case and relied upon an earlier, less specific version of California Wage Order 4. The Supreme Court further ruled that the Court of Appeal had erred in relying primarily on the administrative/production dichotomy, instead of following the language of the relevant wage order and regulations to determine whether the claims adjusters were exempt. The Supreme Court remanded, ordering the Court of Appeal to first apply the language of the statutes and wage order to the facts, and only then, if the statutes and wage order failed to provide sufficient guidance, look to the administrative/production dichotomy.

California Court of Appeal Again Holds that Claims Adjusters Are Non-Exempt

California employees qualify for the administrative exemption from overtime pay requirements if they are (1) paid a high enough salary, (2) perform administrative work, (3) have primary duties that involve administrative work, and (4) discharge those primary duties by regularly exercising discretion and independent judgment. At issue in *Harris* is the second factor—whether the employee's work is administrative.

Both Wage Order 4 and the federal regulations address the administrative exemption in detail. The wage order states that work is considered administrative if it is "directly related" to the management policies or general business operations of the employer. This "directly related" inquiry has two components: a "qualitative" and a "quantitative" measure. The qualitative measure examines whether the work is administrative in nature. The quantitative measure examines whether the work is of "substantial importance" to the management policies or general operations of the employer's business. *Harris* considers only the qualitative measure—the nature of the work.

To consider whether the nature of the claims adjusters' work qualified as exempt administrative work, the Court of Appeal cited the interpretative federal regulations, which provide that an employee's work duties meet the exemption test only if they "relat[e] to the administrative operations of a business as distinguished from 'production.'" Relying heavily on a 1991 Third Circuit case, *Martin v. Cooper Elec. Supply Co.*, and a federal case from Connecticut, the Court of Appeal interpreted this regulation to include only duties involving establishment of management policies or general business operations. Applying this requirement to the facts, the Court of Appeal found that claims adjusters as a whole generally cannot satisfy the qualitative component of the "directly related" requirement because their primary duties involve adjusting individual claims, rather than setting management policy or general operations.

The Court of Appeal then applied the administrative/production dichotomy test in further support of its determination that claims adjusters are non-exempt. The Court of Appeal rejected Liberty Mutual's argument that claims adjusters are exempt under the interpretative federal regulations for the reason that they "service" the business by advising management, planning, negotiating, and representing the company. Again relying on *Martin* from the Third Circuit, the Court of Appeal held that "production" employees do not qualify as exempt employees who are "servicing the business," because they are not formulating general policy on behalf of the business. The Court of Appeal reasoned that claims adjusters were production employees because Liberty Mutual's product is risk transference, and claims adjusting is an essential part of risk transference.

Although the Court of Appeal thus applied the administrative/production dichotomy as near-determinative, with the same result achieved in *Bell*, the Court of Appeal denied that it was following *Bell*, explaining that *Bell* considered the employees' role in the business while the Court of Appeal here was considering only employee duties.

The Court of Appeal expressly declined to follow other federal and administrative authority, including Ninth Circuit decisions, recognizing that claims adjusters qualify for the administrative exemption on the basis that their work is "directly related to management policies or general business operations." The Court of Appeal stated that it is not bound by those other federal decisions and instead preferred to rely on the Third Circuit's decision in *Martin*.

The Court of Appeal also rejected Liberty Mutual's argument that the qualitative component of the "directly related" requirement is not dispositive because the duties of the members of the certified class were so heterogeneous. Instead, the Court of Appeal relied on its categorical conclusion that the claims adjusters did not perform duties involving management policy or general business operations, so they could not be exempt, regardless of the diverse job duties that class members perform.

What *Harris* Means for Employers

The Court of Appeal's decision is highly controversial because of its application of the administrative/production dichotomy, as well as its rejection of seemingly persuasive analogous federal law, including authority in the Ninth Circuit. The panel's decision to essentially reinstate what the Supreme Court had just reversed is difficult to reconcile with the high court's decision. Indeed, the appellate justice who authored the original opinion wrote a dissent from the panel's decision on remand.

The Court of Appeal's decision thus creates significant uncertainty for the trial courts and for employers. If the decision stands, then the administrative exemption in California could have very limited application. Insurance claims adjusters and many other employees currently classified as administratively exempt might have to be reclassified as non-exempt, unless they are among that small group of employees who are primarily involved in setting company policy or running general business operations. We anticipate strenuous efforts to seek review of this decision.

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