Proskauer

newsletter

February 2010
in this issue

Published by Proskauer Rose, the "Employment Law Counseling & Training Tip of the Month" provides best practice tips to assist employers in meeting today's challenging workplace environment. Our Employment Law Counseling & Training Practice Group counsels employers with respect to the interplay of multiple federal, state, and local laws governing today's workplace, helping them avoid workplace problems, and improve employee satisfaction.

Tip of the Month

Tip: How can your company avoid the millions of dollars in monetary damages and litigation costs recently experienced by Staples, Merrill Lynch, and Apple Inc. for misclassifying employees under the Fair Labor Standards Act's ("FLSA") Administrative exemption?

Two recent decisions by the U.S. Court of Appeals for the Second Circuit provide employers with guidance on the proper application of the Administrative exemption to the overtime pay requirements under the FLSA. The decisions serve as an important reminder to employers that they have the burden of demonstrating an employee's primary duty meets *both* substantive prongs of the Administrative exemption test: An employee's primary duty (1) must include the performance of office or non-manual *work directly related to the management or general business operations of the employer or its customers*; and (2) must involve the exercise of discretion and independent judgment concerning matters of significance. To avoid the risk associated with misclassifying employees as exempt from the FLSA's overtime provisions, employers should make careful exemption determinations in light of the revised 2004 regulations and the evolving case law. In addition, employers should conduct payroll practices and classification audits, every so often, so as not to find themselves among the long list of companies forced to defend themselves in the recent wave of wage-hour litigation.

Employer Beware: Misclassifying Employees under the FLSA's Administrative Exemption Can Be Costly

Two recent decisions by the U.S. Court of Appeals for the Second Circuit provide employers with helpful guidance on the proper application of the Administrative exemption to the overtime pay requirements under the Fair Labor Standards Act ("FLSA"). *See Whalen v. J.P. Morgan Chase & Co.*, 587 F.3d 529 (2d Cir. 2009); *Reiseck v. Universal Commc'ns of Miami Inc.*, 591 F.3d 106 (2d Cir.), *aff'd in part*, No. 09-1632 (CV), 2010 WL 75343 (2d Cir. Jan. 11, 2010). In each case, the Appeals Court overturned the lower court's grant of summary judgment in favor of the employer on the issue of whether the employee was exempt from overtime under the FLSA's Administrative exemption, reasoning, that neither employee performed work "directly related to the management or general business operations" of the employer, one of the

two key substantive elements necessary for satisfying the Administrative exemption from overtime.

The decisions serve as an important reminder that *both* substantive prongs of the exemption test must be satisfied for an employee to qualify as a *bona fide* Administrative employee, meaning that the employee's primary duty must include: (1) the performance of office or non-manual work directly related to the management or general business operations of the employer or its customers; *and* (2) the exercise of discretion and independent judgment concerning matters of significance. All too often, employers inadvertently misclassify employees by focusing on the latter prong exclusively, or fail to appreciate that the performance of exempt Administrative duties must be in functional areas of management, running or servicing the employer's business operation itself, and not simply be administrative work supporting the employer's service or production functions. By misclassifying employees, employers open themselves to enforcement actions by the U.S. Department of Labor, private civil suits by misclassified employees, actions by state agencies, and a host of monetary penalties and litigation costs that can result in significant expense.

The FLSA Exemption Analysis for Administrative Employees

Under the FLSA, employers must pay non-exempt employees overtime compensation for time worked in excess of forty hours per week. However, a few categories of employees are exempted from the overtime pay requirements. These include individuals employed in a *bona fide* Administrative capacity, as well as those who are Executives, Professional, Computer Professional, or Outside Sales employees – all terms of art under the FLSA and its regulations. A position falls within the "Administrative" exemption if all three of the following criteria are met:

- the employee is compensated on a salary or fee basis at a rate of not less than $455 per week;
- the employee's primary duty is the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers; and
- the employee's primary duty include the exercise of discretion and independent judgment with respect matters to significance.

29 C.F.R. § 541.200(a).

Significantly, employers bear the burden of establishing entitlement to the FLSA exemptions which, the U.S. Supreme Court has ruled, are narrowly-construed and only apply to those employees who fit squarely within the terms of the exemption. Thus, to classify employees within the Administrative exemption, employers must demonstrate that an employee's duties satisfy *both* its substantive prongs.

Yet, too often, employers fail to pay adequate attention to the individual components of each of the substantive prongs of the Administraive exemption, resulting in the misclassification of personnel they deem important to their operations. Employers have often concluded that the performance of any administrative-type duty constituted exempt work, failing to appreciate the *primary duty* requirement that it be "the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers." *See* 29 C.F.R. § 541.200 and

§ 541.205(a)(3). Alternatively, employers simply concluded that an individual's exercise of "discretion and independent judgment" was enough to place the worker within the Administrative exemption.

In the recent *Whalen* and *Reiseck* decisions, the U.S. Court of Appeals for the Second Circuit re-emphasized that to qualify as an exempt Administrative employee, the employee must *both* perform work "directly related to management policies or general business operations[,]" *and "*customarily and regularly exercise discretion and independent judgment" (in addition to satisfying the salary-basis test). To perform work, "directly related to management policies or general business operations", the Second Circuit clarified that two independent components must be established: *First*, the employee must be performing work that is "administrative" in nature as distinguished from "production" work. *Second*, the work must be shown by the employer to be of "substantial importance" to the management or operation of its business or that of its customer's. In both cases, the Appeals Court observed, the analysis revealed that neither employee performed work directly related to management policies or general business operations.

Administrative vs. Production/Sales Work

In *Whalen*, the Second Circuit ruled that a former loan underwriter for J.P. Morgan Chase & Co. ("Chase") was not exempt from overtime pay as an Administrative employee because his primary duty – selling loan products under detailed directions provided by Chase and at Chase's offices – involved production, not administrative work. The loan underwriter, therefore, "did not perform work directly related to management policies or general business operations" so as to qualify for the FLSA's Administrative exemption from overtime.

Judge Gerard E. Lynch, writing for the Court of Appeals, acknowledged that the line between administrative and production jobs was not a clear one, particularly where the item being "produced" was an intangible service rather than a material good. But Judge Lynch clarified that the line between the two types of jobs "does not track the level of responsibility, importance, or skill needed to perform a particular job." *Whalen,* 587 F.3d at 532-533. The Court noted that factors such as the large monetary value of the loans approved by the underwriter, the employee's salary, and the fact that the loan underwriter worked in a cubicle were irrelevant to the analysis of whether he could be classified as an Administrative employee. Instead, "[w]hat determines whether an underwriter performed production or administrative functions is the nature of her duties[.]" *Id*. at 533.

Analyzing the primary duty of the loan underwriter, the Appeals Court found that he was directly engaged in the "production" of loans. The underwriter's "primary duty was to sell loan products under the detailed directions of the Credit Guide [provided by Chase]" rather than to advise customers about loan products. *Id*. Accordingly, the Second Circuit concluded, Chase's underwriter job duties fell into the category of production, not administrative work, explaining:

> Underwriters at Chase performed work that was primarily functional rather than conceptual. They were not at the heart of the company's business operations. They had no involvement in determining the future strategy or direction of the business, nor did they perform any other function that in any way related to the business's overall efficiency or mode of operation. It is undisputed that the

> underwriters played no role in the establishment of Chase's credit policy. Rather, they were trained only to apply the credit policy as they found it, as it was articulated to them through the Credit Guide.

Whalen, 587 F.3d at 534-535. As such, the loan underwriters' duties were not related either to setting Chase's "management policies" or to running Chase's "general business operations[,]" evidence that employers must establish to satisfy the Administrative exemption.

Since the Appeals Court found that the loan underwriter did not perform any work directly related to management policies or general business operations, Judge Lynch found it unnecessary to determine whether the loan underwriter customarily and regularly exercised discretion and independent judgment with respect to matters of significance, the second substantive element an employer must demonstrate to bring employees within the Administrative exemption from overtime.

In *Reiseck*, the Court of Appeals similarly held that the Administrative exemption did not apply to an advertising salesperson where her duties were not directly related to the management policies or general business operations of her employer, a complimentary travel magazine. The Court, analyzing the case under the then relevant 2002 FLSA regulations, ruled that where the *primary duty* of the salesperson is to sell advertising to individual customers (and not to promote sales generally), that individual does not fall within the FLSA's Administrative exemption.

To reach its conclusion, the Court looked first to the Company's business model. Because the travel magazine for which Reiseck worked was free, the Court determined that "advertising sales [were] a critical source of revenue," and that advertising space was Universal's "product." Since Reiseck's "primary duty was the sale of that product," the Court determined that she could reasonably be considered a sales production employee, but not an Administrative employee.

The Court of Appeals next examined the employer's claim that selling advertising could be considered "promoting sales." The Company argued that by selling advertising, Reiseck "promoted sales" generally, and therefore her duties involved the performance administrative functions. Judge Jose A. Cabranes, writing for the Court, disagreed: "[U]nder that theory, any sales clerk in a retail store would 'promote sales' when assisting potential customers." *Reiseck,* 591 F. 3d at 106-107. Adopting the logic of the Third Circuit in *Martin v. Cooper Elec. Supply Co.*, 940 F.2d 896 (3d Cir. 1991), Judge Cabranes stated that an Administrative employee for the purposes of the FLSA is "an employee encouraging an increase in sales *generally*[,]" not one who is doing the production work of selling. *Id.*

The Second Circuit concluded that Reiseck was "plainly a salesperson" since her primary duty was to "sell specific advertising space to clients." Although the decision that Reiseck did not qualify as an exempt Administrative employee was based on the application of the 2002 FLSA regulations, the Court noted that the same result would be reached under the amended 2004 regulations. Indeed, in the Preamble commentary to the 2004 regulations, the Department of Labor expressly reiterated its long-held view that sales work is nonexempt, overtime-eligible work. Thus, the Court drew an analogy between Reiseck and "an employee whose primary duty is *selling* financial products" directly to clients, who also would not qualify for the Administrative exemption, citing the regulations at 29 C.F.R. § 541.203(b) (2004). *Id*. at 107.

The Court then vacated the lower court's grant of summary judgment in favor of Universal, finding that Reiseck was misclassified because her sales duties related to the production, not administrative, functions of the Company. As with *Whalen*, the Court of Appeals deemed it unnecessary to reach the second question whether the employee's work required "the exercise of discretion and independent judgment." The case was remanded to the lower court to consider whether the employee might qualify for the Outside Sales exemption.

Practice Pointer

The Second Circuit's opinions in *Whalen* and *Reiseck* reveal that employers who fail to take a considered approach when making exemption determinations under the FLSA's intricate regulations and evolving caselaw will do so at their peril. But these decisions tell only half the story. Employers who misclassify their employees face significant exposure – a lesson Apple Inc. recently learned the hard way. On January 22, 2010, Apple agreed to pay almost $1 million to settle a wage-hour class action lawsuit alleging that the company improperly classified its network engineers as exempt Administrative employees and failed to pay them proper overtime. The technology giant is only one in a long line of companies forced to pay huge sums to litigate or settle wage-hour lawsuits. On January 29, 2010, it was announced that Staples, Inc. agreed to a $42 million dollar global settlement of 13 wage-hour lawsuits seeking overtime pay for its current and former assistant store managers, many of whom had been classified as exempt from overtime. On February 10, 2009, a federal judge granted final approval to a whopping $43.5 million settlement, including $10.9 million in legal fees, resolving 11 class and collective actions accusing Merrill Lynch of failing to properly compensate its financial advisors, in part, based on the Company's misclassification of thousands of financial advisors as exempt from overtime pay under the FLSA. These recent wage-hour settlements follow on the heels of Wal-Mart's historic agreement in 2009 to pay as much as $640 million dollars to settle over 63 pending wage-hour lawsuits.

With so much on the line, employers can pro-actively take steps to avoid being engulfed in the wave of wage-hour litigation by conducting payroll practices and classification audit reviews of their exempt job titles, employees, and pay policies and practices to determine (1) whether certain job functions and employees are properly classified as exempt from overtime in light of the 2004 regulations and recent caselaw and (2) whether their respective pay policies/practices comport with state law requirements as well as whether local managers, inadvertently, have encouraged "off-the-clock" work, such as working through meal periods, and failing to record all time worked. Proskauer's Employment Law Counseling Practice Group has extensive experience partnering with Human Resources professionals and assisting employers in the conduct of such classification and payroll practice compliance audits under the FLSA and corollary state wage-hour laws. In addition, we can apply our experience representing employers in the defense of misclassification actions to help guide employers in resolving any problems that surface during a classification and/or payroll audit in a timely and discreet manner.

The Proskauer Rose Employment Law Counseling and Training Practice Group is a multidisciplinary practice group throughout the national and international offices of the firm which advises and counsels clients in all facets of the employment relationship including compliance with federal, state and local labor and employment laws; review and audit of employment practices, including wage-hour and independent contractor audits; advice on regulations; best practices to avoid workplace problems and improve employee satisfaction; management training; and litigation support to resolve existing disputes.

For more information about this practice group, click here or if you have any questions regarding the matters discussed in this Newsletter, please contact any of the lawyers listed below:

NEW YORK

Fredric C. Leffler
212.969.3570 – fleffler@proskauer.com

Marc A. Mandelman
212.969.3113 – mmandelman@proskauer.com

Katharine Parker
212.969.3009 – kparker@proskauer.com

LOS ANGELES

Harold M. Brody
310.284.5625 – hbrody@proskauer.com

BOCA RATON

Allan H. Weitzman
561.995.4760 – aweitzman@proskauer.com

BOSTON

Mark W. Batten
617.526.9850 – mbatten@proskauer.com

NEWARK

John P. Barry
973.274.6081 – jbarry@proskauer.com

Wanda L. Ellert
973.274.3285 – wellert@proskauer.com

NEW ORLEANS

Charles F. Seemann
504.310.4091 – cseemann@proskauer.com

WASHINGTON, D.C.

Lawrence Z. Lorber
202.416.6891 – llorber@proskauer.com

Leslie E. Silverman
202.416.5836 – lsilverman@proskauer.com

Meredith C. Bailey
202.416.6830 – mbailey@proskauer.com