

Second Circuit Narrowly Reads FLSA Exemptions in Novartis Ruling

July 27, 2010

The U.S. Court of Appeals for the Second Circuit issued a significant and potentially far-reaching decision, recently, when it held that Novartis' pharmaceutical sales representatives are entitled to overtime under the Fair Labor Standards Act ("FLSA") and related New York and California laws. The decision, *In re Novartis Wage and Hour Litigation*, No. 09-0437 (2d Cir. July 6, 2010), vacated a lower court's ruling in favor of Novartis Pharmaceuticals Corporation ("Novartis" or "Company"), and rejected Novartis' longstanding practice of classifying its sales representative workforce ("Sales Reps") as exempt from overtime under the outside sales and/or administrative exemptions. In ruling that the Company failed to demonstrate that its pharmaceutical sales representatives satisfied the FLSA's exemption standards, the court gave "controlling deference" to the U.S. Department of Labor's ("USDOL") interpretation of key exemption regulations as set forth in its *amicus brief* in support of the plaintiffs' claims for overtime eligibility. Thus, the Second Circuit found that, while Novartis' Sales Reps were actively promoting pharmaceuticals to physicians to prescribe, they did not have a *primary duty* of *selling* medications or taking orders for them, which it held were necessary prerequisites under the regulations, as the USDOL had argued, for the Sales Reps to fall within the outside sales exemption.

In addition, the court found that the Novartis Sales Reps did not meet the criteria for the administrative exemption because they did not exercise the requisite “discretion and independent judgment with respect to matters of significance,” a term of art under the FLSA’s regulations. For example, the Novartis Sales Reps were, apparently, prohibited from deviating from the Company-supplied core marketing message. For the administrative exemption to apply, the USDOL urged and the Second Circuit held, the regulations required a greater degree of discretion and authority to use independent judgment, such as the making of policy, setting business objectives, or committing the company financially in significant matters, none of which the Sales Reps performed as a *primary duty*.

Notably, the decision conflicts with the Third Circuit’s ruling in *Smith v. Johnson & Johnson*, 593 F.3d 280 (3rd Cir. 2010), finding Johnson & Johnson’s sales representatives to be exempt from overtime based on somewhat similar – though *not* identical – facts. In light of the split in the federal appeals courts, it is possible, therefore, that Novartis may seek en banc reconsideration before the entire Second Circuit, or review in the U.S. Supreme Court.

Rejecting a broad reading of the FLSA’s exemptions, the Second Circuit relied upon the USDOL’s narrow interpretation of the regulations, which may indicate that the current USDOL policy will be to strictly adhere to the standard enunciated by the U.S. Supreme Court in *Arnold v. Ben Kanowsky Inc.*, 361 U.S. 388, 392 (1960), issued some 50 years ago, which deemed the FLSA to be a “remedial law,” that exemptions are “narrowly construed against employers seeking to assert them.” In the wake of this decision, many companies, and particularly those with employees in New York, Connecticut, and Vermont, the geographical reach of the Second Circuit, which have relied upon more recent opinions of the Wage-Hour Division or court rulings giving the exemptions a more expansive reading, may want to audit their classification decisions given the import of this ruling. Moreover, businesses which rely heavily on the Outside Sales and administrative exemptions may find themselves targets of litigation as the plaintiffs’ bar and government regulators seek to extend the reach of the *Novartis* holding to other employers and business sectors.

Factual Background

Novartis hires and trains Sales Reps to market and promote its prescription medications. This task entails visiting doctors' offices to provide physicians with information about the benefits of Novartis' products, and encouraging physicians to prescribe those medications to patients. The Sales Reps deliver a pre-approved "core message" about the drugs to each physician. According to the Second Circuit, the Sales Reps had no role whatsoever in developing the "core message," or in planning the marketing strategy, and were forbidden to answer any question for which there was no scripted response.

The Novartis Sales Reps did not actually sell any prescription medication to the doctors they visited, as such sales are prohibited by law. Instead, they attempt to obtain "commitments" from the doctors to prescribe the medication when appropriate, which obviously then generates sales.

The Sales Reps have control over their daily schedules, checking in with their supervisor bi-weekly. Supervisors occasionally accompany them on physician visits to critique their performance. Sales Reps receive up to 25 percent of their compensation in the form of bonus or incentive payments but are generally paid a weekly salary and earn, on average, \$91,539 per year. Notably, the district court did not consider the Highly Compensated Employee exemption, even though some Sales Reps are paid beyond the \$100,000 annual threshold.

The District Court Finds Pharmaceutical Reps Exempt

The district court, in an opinion by Judge Crotty, held that the Sales Reps qualified under the Outside Sales exemption and, therefore, were not entitled to overtime pay under the FLSA or similar New York and California laws. The court acknowledged that the Sales Reps did not “sell” the medications they promoted in the “technical” sense, but found that the Sales Reps, nevertheless, met the “spirit” and “purpose” of the outside sales exemption, which, according to the court, was to avoid overtime requirements for employees who generate commissions for themselves and work with minimal supervision, “making adherence to an hours-based compensation scheme impractical.” *Slip Op.* at 11. In addition, the district court found that Sales Reps did make “sales” as that term was understood and used in the pharmaceutical industry – because they seek and receive commitments to prescribe from physicians who, ultimately, control the purchase of drugs by patient end-users.

The court also held that the administrative exemption applied, explaining that the Sales Reps engaged in work directly related to the management or general business operations of Novartis in that they were “critical to the dissemination of information about Novartis products.” *Slip Op.* at 12. In addition, the Sales Reps exercised “discretion and independent judgment with respect to matters of significance,” Judge Crotty noted, each time they determined how best to approach a “sale” based on the physician’s needs, which required “initiative to increase the number of prescriptions written.” *Slip Op.* at 13-14. The district court also found that the Sales Reps exercised discretion because they tailored each presentation to convince a diverse audience of physicians to prescribe their products, controlled their own call schedules, and were subject to very little supervisory oversight.

The Second Circuit Reverses - Distinguishes “Promotion” vs. “Sales” and Finds No Exercise of Independent Judgment

The Court of Appeals disagreed with the district court's reasoning under both exemptions, and instead was persuaded by the USDOL's amicus brief that neither the outside sales, nor the administrative exemptions applied on these facts to these Sales Reps. Notably, the Court found that the "Secretary's regulations define and delimit the terms used in the statute; that under those regulations as interpreted by the Secretary, the Reps are not outside salesmen or administrative employees; and that the Secretary's interpretations are entitled to 'controlling' deference," in accordance with U.S. Supreme Court precedent. *Slip Op.* at 16.

Turning first to the outside sales exemption, the court agreed with the USDOL that Novartis' Sales Reps do not "make sales" or obtain orders within the meaning of the FLSA or its regulations. The applicable regulations define sales as involving essentially a transfer of title or contract to sell. The court concluded that the Novartis Sales Reps merely "promote" pharmaceutical products to physicians who cannot lawfully make a binding commitment to prescribe them, and are not making the actual sales to wholesalers and pharmacies. Hence, the Second Circuit ruled, the Sales Rep "does not in any sense make the sale. Thus, the interpretation of the regulations given by the Secretary in her position as *amicus* on this appeal is entirely consistent with the regulations." *Slip Op.* at 23.

In addressing the administrative exemption, the Court of Appeals scrutinized the USDOL's interpretation of its regulations as set out in its amicus brief. While the court did not discuss whether the Sales Reps performed work directly related to Novartis' general business operations (a necessary element that employers must demonstrate), it found "no evidence in the record that the Reps have any authority to formulate, affect, interpret, or implement Novartis' management policies or its operating practices, or that they are involved in planning Novartis' long-term or short-term business objectives ... or that they have any authority to commit Novartis in matters that have significant financial impact". *Slip Op.* at 30. In short, the court agreed with the USDOL's view that this record was barren of persuasive evidence that the Novartis Sales Reps exercised discretion and independent judgment as a *primary duty*. *Slip Op.* at 24. The court also concluded that any independent judgment was "exercised within severe limits imposed by Novartis." *Slip Op.* at 31. The court explained that "[w]hat Novartis characterizes, as the Reps' exercise of discretion and independent judgment ... are skills gained and/or honed in their Novartis training sessions." *Slip Op.* at 31. Deferring to the Secretary's *amicus brief*, the court noted that the regulations make clear that the exercise of discretion and judgment means more than using skill in applying well-established techniques or procedures prescribed by the employer.

Given that the Novartis Sales Reps could not "lawfully transfer ownership of any quantity of drug in exchange for anything of value", and exercised judgment or skills within "severe limits imposed by Novartis," the Second Circuit held that the Sales Reps neither made a sale, nor exercised independent judgment with respect to "matters of significance", to fall within the FLSA's outside sales or administrative exemptions.

Third Circuit Rules Pharmaceutical Sales Rep Exempt Under Administrative Exemption

In contrast to the *Novartis* decision, the Third Circuit recently held that a pharmaceutical Sales Rep, with duties and restrictions similar to those at issue in *In re Novartis*, satisfied the FLSA's Administrative exemption from overtime. *Smith v. Johnson & Johnson*, 593 F.3d 280 (3rd Cir. 2010). In that case, although Sales Rep, Patty Smith, marketed (but did not sell) pharmaceuticals to physicians, Johnson & Johnson was able to establish that she exercised discretion because she determined the frequency of visits to physicians in her territory and, most importantly, had freedom to develop her own "strategic plan" to maximize "sales" in her territory.

Thus, the Third Circuit held, Smith qualified under the administrative exemption. The court was apparently impressed that plaintiff Smith "described herself as the manager of her own business who could run her own territory as she saw fit." *Id.* at 282-283. No doubt, plaintiff's concession influenced the Third Circuit's thinking as the court limited its holding to "the specific facts developed in discovery in this case." The court recognized that "based on different facts, courts, including this court, considering similar issues involving sales representatives for other pharmaceutical companies, or perhaps even for J&J, might reach a different result than that we reach here." *Id.* at 283, n. 1. The outside sales exemption was not before the court in that case.

Impact on Employers - What Should You Do Now?

While often there is risk associated with any classification decision, based on the Second Circuit's decision in *Novartis* and the U.S. Department of Labor's vested interest in the matter, employers should closely scrutinize the classification of outside sales representatives as exempt from overtime. Similarly, with respect to the administrative exemption, employers should assess whether employees so classified satisfy at least two or three of the ten criteria set out in the regulations for determining if an employee exercises independent judgment with respect to "matters of significance." Although the landscape will continue to remain muddy in connection with pharmaceutical sales representatives, as more courts weigh in, because the classification determination is so fact intensive. Indeed, this issue may not be resolved with any finality unless the U.S. Supreme Court weighs-in finding "promotion" work by itself suffices for the outside sales exemption. Nevertheless, in light of *Novartis*, there are a number of important lessons that companies should keep in mind going-forward.

First, employers who have not recently done so may want to consider a wage-hour classification audit of selected jobs and a payroll practices audit. The *Novartis* decision reminds us that the exemptions from overtime under the FLSA tend to be narrowly construed and that the employer bears the burden of demonstrating that the employee at issue meets all elements of the criteria. In light of increased activity by both federal and state regulators, not to mention a very active plaintiffs' bar which is pursuing misclassification and "off-the-clock" timekeeping cases with enormous energy because they can be so lucrative, employers may be well advised to conduct a periodic review of their employee classifications and payroll practices. Taking proactive steps to ensure compliance can be a cost-saver given litigation costs and backpay exposure (two or three years, but can extend to four or six years under some state laws, such as in California or New York) plus potential for liquidated (double) damages. Proskauer's Employment Law Counseling Practice Group has extensive experience assisting employers with wage-hour classification and compliance audits under the FLSA and corollary state wage-hour laws as well as training human resources professionals in this area of the law. In addition, we can apply our experience representing employers in the defense of actions alleging misclassification under the FLSA to help ensure that problems which surface during a classification and/or payroll practices audit are resolved in a timely and discreet manner.

Second, the outside sales exemption's application to employees who primarily "promote" but who do not actually "make sales," or obtain orders or contracts for services, may no longer be sufficient in the Second Circuit. Thus, to minimize litigation risk, it is best if there is demonstrable evidence that the outside sales force is actually engaged in making sales. In addition, employers should check that their outside salespeople are "customarily and regularly" away from the employer's place of business performing such *primary duty*. Although the Third Circuit did not rule on the "promoting" vs. "sales" issue, and a challenge under California's (similar) state law exemption is currently pending before the California Supreme Court, it is now clear in the Second Circuit that the "promoting sales" analysis without actual sales or orders may not be sufficient to carry the day for businesses who rely on it. Indeed, the Second Circuit suggested that the pharmaceutical industry re-direct its efforts to Congress, and not the courts.

Third, with respect to the administrative exemption’s application, the Second Circuit has signaled that it supports the USDOL’s narrow interpretation of the exemptions. This means employers should evaluate whether their employees meet the essential regulatory criteria to fall within the administrative exemption, such as by reporting to one of the functional areas of management described in the regulations to demonstrate that they perform work related to the managing or servicing the Company’s business operation (or that of its customers), thereby satisfying the first substantive criterion of the administrative exemption. In addition, job duties should be evaluated with an eye on ensuring that employees exercise “discretion and independent judgment” regarding “matters of significance” in carrying out their *primary duties*, as these terms of art are understood and interpreted under the FLSA.

If you have any questions about this client alert, please contact your Proskauer relationship lawyer or any of the members of Proskauer’s Employment Law Counseling and Training Practice Group.

*Special thanks to associate **Carolyn Dellatore** for her assistance in drafting this client alert.*

[Related Professionals](#)

- **Nigel F. Telman**
Partner
- **Mark W. Batten**
Partner