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“Exempt” Status Under California Law: Avoid the Pitfalls

by Jennifer Brown Shaw

In the past several years, California employers have struggled to understand which of their employees may be properly classified as “exempt” under California law. Those employees are “exempt” from minimum wage and overtime (and other compensation, such as reporting time and call back pay), and required to take rest breaks and meal periods. Part of the confusion stems from the fact that the requirements for exempt status under the federal Fair Labor Standards Act (FLSA) are different in many ways from the California requirements. While these differences are not new, the recent flood of class action litigation regarding which employees are properly due overtime necessarily has generated keen interest in compliance.

Under both federal and state law, employers bear the burden of proving an exemption applies (that the employee is appropriately classified as exempt). Because the consequences of misclassification can be significant (e.g., unpaid overtime for up to four years, penalties for missed breaks and meal periods, attorneys’ fees, etc.), it pays to understand some basic principles of employee classification.

Overview of the “White Collar” Exemptions

Each of the California Industrial Welfare Commission’s wage orders contains “white collar” exemptions for executive, administrative, and professional employees. To qualify for any of these exemptions, an individual must satisfy both “salary” and “duties” requirements. The wage orders contain a detailed description of the requirements for each exemption.

The salary requirements for each exemption are the same: the individual must be paid a fixed salary equal to at least two times the state’s minimum wage. The salary may not be subject to change based on the employee’s quality or quantity of work. A common mistake employers make in this area is including commissions when determining whether employees meet the salary requirement. Payments such as bonuses and commissions may be paid in addition to the base salary, but may not be considered as part of the fixed salary requirement. Certain deductions are permitted to the salaries of exempt employees, but that is a topic for another day. The minimum salary requirement currently is \$31,200 per year. When the minimum wage increases to \$8.00 per hour on January 1, 2008, the minimum annual salary for exempt employees will increase to \$33,280.

The duties test for all three white collar exemptions requires exempt employees to be “primarily engaged in” the duties that qualify for the exemption, described below. In California, “primarily” means more than one-half of the employee’s work time must be spent engaged in exempt work (a quantitative test). This is a different standard from the FLSA, which requires only that the employee’s “primary duty” be exempt (a qualitative test). In addition, under both state and federal law, exempt employees must customarily and regularly exercise “discretion and independent judgment” in performing their duties.

Employers frequently misapply the terms “discretion” and “independent judgment” to situations in which an employee uses his or

her knowledge to apply established procedures or determine which procedures to follow. Although all employees use discretion to some extent in performing job duties, an employee covered by the one of the “white collar” exemptions must do more than follow established procedures or choose among various prescribed alternatives.

The Executive Exemption

This exemption applies generally to “management” employees who supervise at least two or more full-time employees on a regular basis. They must have the authority to hire or fire other employees (or their recommendations as to hiring or firing others or other changes of status must be given particular weight).

The executive’s primary duty is to manage a recognized unit that has a continuing function. Exempt management duties include, for example, interviewing, selecting, and training employees; setting and adjusting employees’ rates of pay and hours of work; evaluating employee’s efficiency for the purpose of recommending promotions or other changes in their status; handling employee complaints and grievances and disciplining employees when necessary; determining the type of materials, supplied, machinery, or tools to be used or merchandise to be bought, stock, and sold; and providing for the safety of the employees and the property. “Production” duties performed by a non-exempt employee, such as preparing the product for sale, selling, or organizing stock, will not be considered exempt duties. Only duties that are “closely related” to management functions will be considered exempt.

The Administrative Exemption

To satisfy the administrative exemption, an employee must perform office or non-manual work that is directly related to the management policies or general business operations of the employer or the employer's customers. Employers mistakenly apply the administrative exemption to situations in which employees exercise independence and discretion in their positions (for example, insurance underwriters or brokers), but are not performing "administrative" work relating to the employer's policies or operations. Rather, such employees fulfill a "production" function in the organization because the duties directly relate to the generation of revenue.

A California Court of Appeal decision in this area, *Bell v. Farmers Insurance Exchange*, is particularly instructive. In that case, the court held that claims representatives for an insurance company were not administrative employees. In reaching its decision, the court considered the distinction between "administrative" employees and "production" employees. Because Farmers Insurance Exchange's primary business was handling insurance claims, and the claims representatives spent the majority of their time at work handling claims, the court determined they were production employees and therefore not covered by the administrative exemption. The court reached this conclusion even though the work the employees performed was non-manual, office work that involved some discretion and exercise of independent judgment.

In determining whether an employee falls into the administrative or production category, employers should consider three distinct criteria: (1) the employee's role in the employer's business; (2) the employee's actual job duties; and (3) the employee's earnings. Some of the duties found to be administrative in nature include advising management; planning; negotiating; purchasing; promoting sales; business research and control; improving client services; reconciling payroll bank accounts; auditing

payroll earnings and deductions; developing systems and programs to streamline office procedures; and making personnel recommendations.

Professional Exemption

The professional exemption generally applies to two categories of employees. The first category is comprised of individuals who are licensed by the State of California and primarily engaged in the practice of law, medicine, dentistry, optometry, architecture, engineering, teaching, or accounting. (Note, pharmacists and most nurses expressly are excluded from this exemption.)

A common mistake in this area is classifying as exempt those employees who have not yet received their licenses. In addition, with the exception of certain high-level, "computer" professionals (discussed below), employees paid hourly rather than a salary are misclassified as exempt under the professional exemption, even if they satisfy the duties test.

The second category of employees that may be covered under this exemption are those engaged in a "learned or artistic profession." The California Division of Labor Standards Enforcement (DLSE) recently adopted as its enforcement position prior federal standards regarding this exemption. The DLSE's enforcement position now is consistent with the federal Department of Labor's regulations as they existed before they were revised (and loosened) in 2004.

In particular, the DLSE clarified that the "learned" professional exemption now requires learning only above the high school level. Employees no longer are required to have post-bachelor's degrees. However, the degree must be in the field of science or learning, and it must be required by the employee's position.

Other Exemptions

California recognizes other overtime exemptions that also contain traps for the unwary:

Computer Professionals. While there is

an exemption for certain computer professionals, the compensation requirement is different from the salary test for the white collar exemptions. Under the computer professional exemption, an employee must be paid an hourly rate (or equivalent salary) of at least \$49.77 per hour in 2007. This hourly rate adjusts for inflation annually. The employee must perform higher level tasks related to computer programming (as opposed to input) as detailed in the wage orders.

Employers who do not pay their IT professionals the compensation required for the computer professional exemption may attempt to classify those employees as exempt under one of the other exemptions. Before doing so, however, those employers must carefully consider whether the computer professional's duties are consistent with the requirements of the executive or administrative exemption.

Salespersons. California also recognizes an exemption for certain salespersons.

The "outside sales" exemption applies to employees who are 18 years of age or older and spend more than one-half of their working time away from the employer's place of business "selling" or obtaining orders or contracts for products, services or use of facilities. Outside salespersons are not required to meet the salary test that applies to the executive, administrative, and executive exemptions.

Unlike federal law, California does not consider as "exempt work" duties incidental to the employee's sales or solicitations, including incidental deliveries and collections. This distinction is particularly important for route salespeople and others who perform many functions other than sales in an average day, such as delivery, repair, and maintenance.

There is also an "inside sales" exemption applicable to employees covered by Wage Order 4 (professional) and Wage Order 7 (retail) if their earnings exceed one-and-one-half times the minimum wage and more than one-half their compensation

represents commissions. It is important to note this exemption applies to overtime only, and not to other wage and hour laws (such as rest breaks and meal period requirements).

One item to note here: if there is a guaranteed draw against commissions, the Labor Commissioner may consider the earnings as salary and not commissions, which would render the exemption inapplicable. Also, because the inside sales exemption is based in part upon the amount of earnings attributable to commissions, those earnings must satisfy the definition of “commissions” under the California Labor Code. Finally, those employers who would not qualify as “retailers” should ensure the classification of inside salespersons as exempt qualifies under federal law (known as the “7(i)” exemption).

Conclusion

To avoid liability for misclassification, employers should critically evaluate whether employees designated as “exempt” meet the compensation and duties test required for the various exemptions. Then, if certain employees have been misclassified as exempt, the employers should work with experienced employment counsel who may be able to minimize potential liability for unpaid overtime, penalties, and other consequences associated with misclassification.

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