

# CORNELL HR REVIEW

## THE VALUE OF DISCRETION

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### Introduction

In Shakespeare's *Henry IV*, the lazy and lecherous Sir John Falstaff is attacked during battle, falls to the ground, and feigns his death. Falstaff attempts to justify his act of cowardice by explaining: "The better part of valor is discretion, in the which better part I have sav'd my life."<sup>1</sup> By exercising his "discretion" to fake his death, Falstaff rationalizes that he is free to live to fight another day.

There is little to be lauded in Falstaff's distorted worldview. Yet, employers may find something illuminating in Falstaff's value of "discretion." Employers can forego paying minimum wages and overtime compensation if their employees qualify under one of many exemptions provided for under the Fair Labor Standards Act (FLSA) or its state counterparts. The most commonly invoked of these exemptions — the administrative exemption — requires that employees exercise "discretion and independent judgment" in the performance of their primary job duties.

The ability of employees to exercise the requisite degree of discretion and independent judgment, however, is under attack. Washington has been running at a record-setting pace in promulgating rules and regulations under the current and prior White House administrations. More than 50 federal agencies currently enforce over 150,000 pages of regulations that touch nearly every aspect of a company's operations. These regulations do not come without a cost. Many of these costs are, by nature, unknowable, but one cost is certain — the growing body of regulations places constraints on employees' ability to exercise discretion and independent judgment in doing their jobs, jeopardizing their status as exempt administrative employees.

Employers, therefore, have a fight on their hands as regulatory burdens increase at a staggering pace. Sir John Falstaff valued the discretion he exercised on the battlefield; employers, too, should prize the discretion exercised by their employees in the workplace. It is essential to them winning the battle of preserving the exempt status of many of their employees.<sup>2</sup>

### Historical Background

On June 25, 1938, President Franklin D. Roosevelt signed the Fair Labor Standards Act into law to extend relief to America's "ill-nourished, ill-clad, and ill-housed"<sup>3</sup> — of which there was no shortage during the Great Depression. The FLSA implemented two key mechanisms to provide that relief. First, it set a ceiling on the number of hours in the

workweek and mandated that employers pay a premium wage to all employees who worked in excess of that weekly limit. Second, the FLSA fixed a floor on the wages paid to employees.

The FLSA, however, did not extend the benefits of overtime and minimum wages to all workers. It created a series of “exemptions” from these wage and hour requirements for specific classes of employees.

No group of exemptions has become more significant than the so-called “white-collar” exemptions, which apply to those employed in “a bona fide executive, administrative, or professional capacity.”<sup>4</sup> And no single exemption is invoked more and understood less than the “administrative exemption.” The exemption applies to the employee (1) “[w]hose 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,” (2) “[w]hose primary duty includes the exercise of discretion and independent judgment with respect to matters of significance,” and (3) who is “[c]ompensated on a salary or fee basis at a rate of not less than \$455 per week.”<sup>5</sup> Although it has been around for over 70 years, the exemption has “generated significant confusion and litigation” and “become increasingly difficult to apply with uniformity in the 21st century workplace.”<sup>6</sup>

One layer of the confusion is the sheer scope of job duties that fall under the exemption. By extending the scope of the administrative exemption to those whose primary duty is related to an employer’s ambiguous “general business operations,” the U.S. Department of Labor (DOL) created a vacuous exemption that can seemingly swallow vast groups of workers. Federal courts have found the exemption to apply to certain sales representatives, underwriters, insurance claims adjusters, accountants, jailers, school principals, racing officials, family counselors, property managers, technical writers, fire chiefs, private investigators, event coordinators, recruiters, engineers, and securities brokers. Administrative employees interview, inspect, negotiate, recommend, analyze, advise, evaluate, investigate, plan, network, represent, and resolve. They might work in “tax; finance; accounting; budgeting; auditing; insurance; quality control; purchasing; procurement; advertising; marketing; research; safety and health; personnel management; human resources; employee benefits; labor relations; public relations, government relations; computer network, internet and database administration; legal and regulatory compliance.”<sup>7</sup> It is safe to say that there is no prototypical administrative employee. It is also safe to say that many employers “get it wrong” when classifying workers as “administrative employees.”

Part of the confusion derives from the difficulty in understanding the manner in which administrative employees operate with “discretion and independent judgment,” as required by the regulations. The “discretion and independent judgment” language has been a source of consternation since its genesis. In 1940, opponents challenged it as vague and called for its exclusion.<sup>8</sup> In 1949, the DOL conceded that the phrase was not “precise” and had been “misunderstood and misapplied by employers and employees.”<sup>9</sup> In 2004, when the DOL revised the regulations, it reiterated that this language had

“caused confusion and unnecessary litigation” and had “become progressively more difficult to apply” with the passage of time.<sup>10</sup> Still, it remains today and is a continuous source of litigation and cost for employers.

### Meaning

Three key terms are at issue: “discretion,” “independent,” and “judgment.” Although related (and arguably overlapping) in meaning, they each provide a different focus. The *Oxford English Dictionary* defines “discretion” to mean “[t]he action of separating or distinguishing[;]”<sup>11</sup> “independent” to mean “[n]ot depending upon the authority of another”;<sup>12</sup> and “judgment” to mean “[t]he formation of an opinion or notion concerning something by exercising the mind upon it.”<sup>13</sup>

The DOL embodies these three concepts in the current regulations defining “discretion and independent judgment” to “involve[] the comparison and the evaluation of possible courses of conduct, and acting or making a decision after the various possibilities have been considered.” The phrase further “implies that the employee has authority to make an independent choice, free from immediate direction or supervision.”<sup>14</sup> In summary, employees must have the freedom to distinguish among the alternative ways of performing their job and possess the authority to decide which path they will take — and do so on their own.

### Regulating “Discretion and Independent Judgment”

Before the 20th century, social wrongs in this country were addressed primarily through private litigation.<sup>15</sup> At the turn of the century, during the so-called Progressive Era, the government assumed an affirmative role in resolving many of these wrongs.<sup>16</sup> Its regulatory efforts during this era — such as the Federal Reserve Act and Clayton Act — still impact our country today.

Since that time, the government has dramatically enlarged its regulatory role. The alphabet soup of federal agencies that currently exists, ranging from the EPA to the DOE to OSHA, enforce over 150,000 pages of rules that touch virtually every aspect of society, from the handling of hazardous waste to the type of light bulb Americans can use in their homes.<sup>17</sup> Indeed, since 1995, nearly 64,000 federal rules have issued.<sup>18</sup>

The pace of agency rulemaking is staggering. Between October 2010 and April 2011, 1,827 rulemaking proceedings were completed.<sup>19</sup> In 2010 alone, federal agencies issued 3,573 final rules — the equivalent of nearly 10 rules a day.<sup>20</sup> By the end of 2011, the *Federal Register*, the official publication that includes all proposed and final federal rules and regulations, totaled a record-setting 82,419 pages.<sup>21</sup>

And they keep on coming. According to the spring 2011 Unified Agenda, a compendium of upcoming rules, there are 2,785 proposed or final rules on the horizon, 144 of which are classified as “economically significant” (i.e., costing at least \$100 million annually).<sup>22</sup>

The army of federal agency employees needed to enforce the horde of regulations grows by thousands each year.

Apart from increasing the number of regulations, the DOL is vigorously enforcing federal labor and employment laws that are already on the books. During the prior fiscal year alone, the Wage and Hour Division collected nearly \$225,000,000 in back wages from employers — the largest amount collected in a single year in the Division’s history.<sup>23</sup>

In particular, it is committed to ending employee misclassification. At the end of last year, before the House Subcommittee on Workforce Protections Committee on Education and the Workforce, the Deputy Administrator of the Wage and Hour Division testified that “employee misclassification is a serious and, according to all available evidence, growing problem” that the Obama Administration is “committed to working to end.”<sup>24</sup> She also stressed the state and federal agencies are combining their resources, coordinating their efforts, and sharing information to achieve compliance with employee classification standards.

### **The Cost of Regulation**

The volume of government regulations is a source of significant controversy. The debate often focuses on the issues of cost, and specifically, the cost of the growing mountain of regulations on businesses. A 2011 report, for example, determined that the cost for businesses to comply with federal regulations was in excess of \$1.75 trillion.<sup>25</sup>

There is one regulatory cost, however, that almost always goes unnoticed — the exempt status of employees. The exempt status of administrative employees turns on the exercise of their discretion and independent judgment. Their ability to exercise discretion and independent judgment turns on their ability to make decisions. But that capacity to make decisions is diminished as government agencies load employers with an ever-growing body of rules and regulations that they must pass on to their workers in the form of rules, directives, policies, procedures, and protocols — all of which govern and circumscribe how the employees do their job.

One industry that is experiencing firsthand the cost of regulations on exempt status is the pharmaceutical industry. All actors in this industry are subject to regulatory controls. In particular, the relationship between sales representatives and prescribing physicians has become the focus of intense regulatory oversight. The regulations, a product of the potential conflicting interests between these two parties, seek to prevent improper exchanges of information or gifts to influence prescription-writing and drug sales.

Drug companies have responded with guidelines and policies that govern the actions of their sales representatives. Depending on the employer, sales representatives can have rules or restrictions on which doctors they can see, how many times they must see them, what drugs they can promote, which questions they can answer, what they can say during a sales call, what visual aids they can use, and the kind of meals or events to which they can take their doctor-clients.

There has been a cost. Although industry practice has treated sales representatives as exempt employees for well over a half-century, this practice has come under attack in the last decade with nationwide litigation against virtually every prominent pharmaceutical manufacturer. And one line of attack has been the lack of discretion and independent judgment sales representatives exercise due to the stringent rules imposed on them.

Among the most prominent of these decisions has been against Novartis International. A class of some 2,500 exempt sales representatives employed in California and New York sued Novartis for unpaid overtime compensation.<sup>26</sup> The sales representatives challenged their exempt status, contending that their jobs merely consisted of “low-level, discretionless marketing work, strictly controlled by Novartis.”<sup>27</sup>

The New York district court and Second Circuit Court of Appeals agreed. On appeal, the Second Circuit determined that Novartis had imposed too many limits on the sales representatives. It highlighted, for example, that Novartis imposed “severe limits” on what sales representatives could say in their calls with the prescribing physicians: Novartis developed the “core message” that the representatives presented to the physicians, and the representatives could not deviate from that message.<sup>28</sup> Accordingly, the Court of Appeals held that the sales representatives did not sufficiently exercise either discretion or independent judgment, depriving them of their exempt status under the administrative exemption.<sup>29</sup>

Following this decision, after litigating the wage-and-hour class action for nearly six years and certainly incurring millions in attorneys’ fees, Novartis decided to settle. On January 25, 2012, a New York federal district court issued an order granting preliminary approval of a \$99 million proposed settlement arising from the sales representative litigation.<sup>30</sup>

### **Managing and Maintaining Discretion**

The pharmaceutical industry is only one of many currently fighting to keep its head above regulatory waters. The web of regulations issuing from government agencies is entangling more and more employers and entangling them in new and different ways. In these sectors of the economy, employers are increasingly vulnerable in their reliance upon the administrative exemption. But there are legal principles upon which employers can build a foundation for discretion and independent judgment to survive and even thrive in the workplace.

First, the fact of regulation — even heavy regulation — does not preclude the exercise of discretion and independent judgment, according to many courts around the country. In the last decade, there have been several notable decisions involving professionals who work in the nuclear power industry, which is subject to intense government oversight.<sup>31</sup> In two of these cases, the Sixth Circuit Court of Appeals rejected the employees’ argument that “the heavily-regulated nature of their primary job duty prohibit[ed] their exercise of discretion and independent judgment.”<sup>32</sup> Instead, it analyzed the existence of

discretion and independent judgment within the constraints of the regulations. Although it acknowledged that the practical effect of the regulations was to minimize discretion, it held that the employees worked under circumstances that allowed them to independently determine the manner in which they performed their job. The Sixth Circuit highlighted the distinction between providing an employee a “guideline” on how to perform his or her job and providing “an encyclopedia of strict requirements.”<sup>33</sup>

Likewise, despite regulations applicable to the pharmaceutical industry, federal courts have found that sales representatives exercise discretion and independent judgment within the limits set by those regulations. For example, the Third Circuit Court of Appeals has determined that sales representatives exercise discretion and are exempt administrative employees because they are free to determine the manner in which they approach physicians, “whether it be through access meals, peer-to-peer meetings, or other means.” They also have the ability to alter their marketing strategy based upon their circumstances.<sup>34</sup>

Second, under the FLSA and many state counterparts, an employee need only exercise a modest degree of discretion and independent judgment to qualify as an administrative employee. Before August 2004, an exempt administrative employee had to “customarily and regularly” exercise discretion and independent judgment in performing his or her primary duties.<sup>35</sup> The Wage and Hour Division, however, removed the “customarily and regularly” language from the discretion and independent judgment prong in its 2004 amended regulations. Now, under federal law, an exempt administrative employee’s primary duties need only “include[]” the exercise of discretion and independent judgment.<sup>36</sup>

Third, the DOL has determined that certain duties inherently involve the exercise of discretion and independent judgment. Employers can strengthen the exempt status of their employees by ensuring that their primary duties include two or more of the following:

- formulating, affecting, interpreting, or implementing management policies or operating practices;
- carrying out major assignments in conducting business operations;
- performing work that affects business operations to a substantial degree;
- committing the employer in matters that have significant financial impact;
- waiving or deviating from established policies and procedures without prior approval;
- negotiating and binding the company on significant matters;
- providing consultation or expert advice to management;
- planning long- or short-term business objectives;
- investigating and resolving matters of significance on behalf of management; and
- representing the company in handling complaints, arbitrating disputes, or resolving grievances.<sup>37</sup>

Although this list is not exhaustive, there is safety for employers in staying close to the regulations.

Fourth, the employee must exercise discretion and independent judgment as to “matters of significance.” Courts recognize that nearly all employees exercise *some* discretion. Most employees, for example, exercise discretion in choosing the order in which they perform their job duties. But to qualify for exempt status, the discretion and independent judgment exercised must be substantial in that it has some importance or consequence for the employer.<sup>38</sup> Thus, employers can shore up the exempt status of their administrative employees by ensuring that they are making decisions that can and do have an impact upon the business.

Finally, the fact that the employee does not have sole or final authority to make decisions does not disqualify the employee from exercising discretion and independent judgment. The exempt administrative employee’s decision may be subject to further review and even subject to reversal without jeopardizing his or her exempt status. So long as the employee is at least making recommendations to his or her superior, the employee can still exercise sufficient exercise and independent judgment to fall under the exemption.<sup>39</sup>

Despite the tsunami of regulations burdening so many sectors of the economy, employers can preserve the discretion and independent judgment of their exempt workers. So long as they structure the work of their employees to include the ability and authority to independently act in a manner that has a real and substantial impact on the enterprise, employers can keep the administrative exemption alive in the workplace.

### **Conclusion**

The maze of government regulations is increasing, and the space within which employees can exercise discretion is constricting. But discretion and independent judgment can survive regulation. Employers can structure their policies and procedures, within the legal limits set by the applicable government regulations, to channel but not eliminate their employees’ discretion and independent judgment. If employers enable and enhance their employees’ freedom to decide how to perform their job duties, and provide them with the authority to perform their job accordingly, employers can preserve the exempt status of their administrative employees.

For Sir John Falstaff, the exercise of discretion saved his life. For employers, the exercise of discretion can save the exempt status of their employees. ❧

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<sup>1</sup> *Henry The Fourth*, Part 1 Act 5, scene 4, 115–121.

<sup>2</sup> There are other exemptions, such as the professional exemption, that require the exercise of discretion and independent judgment. This article focuses solely on the administrative exemption.

<sup>3</sup> S.REP. NO. 884, 75th Cong., 1st Sess. 1-3 (1937).

<sup>4</sup> 29 U.S.C. § 213(a)(1).

<sup>5</sup> 29 C.F.R. § 541.200.

<sup>6</sup> Dep't of Labor, Wage and Hour Division, Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 69 Fed. Reg. 22,122, 22,142 (Apr. 23, 2004) (to be codified at 29 C.F.R. pt. 541).

<sup>7</sup> 29 C.F.R. § 541.201(b).

<sup>8</sup> Dep't of Labor, Wage and Hour Division, "Report and Recommendations of the Presiding Officer at Public Hearings on Proposed Revisions of Regulations, Part 541: Defining the Terms 'Executive[,] 'Administrative[,] 'Professional[,] 'Local Retailing Capacity[,] 'Outside Salesman' as Contained in Section 13(a)(1) of the Fair Labor Standards Act, at 13, 37 (October 10, 1940) ["Stein Report"].

<sup>9</sup> Harry Weiss, Report and Recommendations on Proposed Revisions of Regulations, Part 541, at 65 (1949) [hereinafter "Weiss Report"].

<sup>10</sup> Dep't of Labor, Wage and Hour Division, Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 69 Fed. Reg. 22,122, 22,142 (Apr. 23, 2004) (to be codified at 29 C.F.R. pt. 541).

<sup>11</sup> THE OXFORD ENGLISH DICTIONARY, vol. IV, 756, col. 2. (Second ed. 1989).

<sup>12</sup> THE OXFORD ENGLISH DICTIONARY, vol. VII, 848, col. 1. (Second ed. 1989).

<sup>13</sup> THE OXFORD ENGLISH DICTIONARY, vo. VIII, 294, col. 3. (Second ed. 1989).

<sup>14</sup> 29 C.F.R. §§ 541.202(a), (c).

<sup>15</sup> Edward L. Glaeser and Andrei Shleifer, *The Rise of the Regulatory State*, JOURNAL OF ECONOMIC LITERATURE, vol. XLI, 401, 401-02 (June 2003).

<sup>16</sup> *Id.*

<sup>17</sup> Congressional Update, U.S. Federal News (Jan. 27, 2011) (comments by Representative Mary Bono Mack).

<sup>18</sup> Clyde Wayne Chews Jr., *Ten Thousand Commandments: An Annual Snapshot of the Federal Regulatory State* 17 (2011), available at <http://cei.org/sites/default/files/Wayne%20Crews%20-%202010,000%20Commandments%202011.pdf>.

<sup>19</sup> James Gattuso and Diane Katz, *Red Tape Rising: A 2011 Mid-Year Report*, July 25, 2011, available at [http://www.heritage.org/research/reports/2011/07/red-tape-rising-a-2011-mid-year-report#\\_edn3](http://www.heritage.org/research/reports/2011/07/red-tape-rising-a-2011-mid-year-report#_edn3).

<sup>20</sup> Clyde Wayne Chews Jr., *Ten Thousand Commandments: An Annual Snapshot of the Federal Regulatory State* 17 (2011), available at <http://cei.org/sites/default/files/Wayne%20Crews%20-%202010,000%20Commandments%202011.pdf>.

<sup>21</sup> Congressional Documents and Publications, *House Judiciary Subcommittee on Courts, Commercial and Administrative Law Hearing*, Mar. 21, 2012 (testimony by Richard Williams, Director of Policy Research).

<sup>22</sup> Diane Katz, *President Obama's Regulatory Bait-and-Switch*, Aug. 24, 2011, available at <http://blog.heritage.org/2011/08/24/president-obama's-regulatory-bait-and-switch/>.

<sup>23</sup> Testimony of Nancy J. Leppink, Deputy Wage and Hour Administrator Wage and Hour Division, U.S. Department of Labor before the Subcommittee on Workforce Protections Committee on Education and the Workforce U.S. House of Representatives (Nov. 3, 2011), available at [http://www.dol.gov/\\_sec/media/congress/20111103\\_Leppink.htm](http://www.dol.gov/_sec/media/congress/20111103_Leppink.htm).

<sup>24</sup> *Id.*

<sup>25</sup> *Chews*, *supra* note 14, at 7.

<sup>26</sup> *In re Novartis Wage and Hour Litigation*, 611 F.3d 141, 144 (2d Cir. 2010).

<sup>27</sup> *Id.* at 156.

<sup>28</sup> *Id.* at 157.

<sup>29</sup> *Id.* at 157. Pharmaceutical sales representatives have also challenged their exempt status under the outside sales exemption, which does not require "discretion and independent judgment." In *Novartis*, the Second Circuit held that the outside sales exemption does not apply in this context because sales representatives do not "make sales" within the meaning of the FLSA. *Id.* at 150-55. The Ninth Circuit disagreed in *Christopher v. SmithKline Beecham Corp.*, 635 F.3d 383 (9th Cir. 2011), creating a circuit split. In November 2011, the U.S. Supreme Court granted the petition for writ of certiorari from *Christopher* and will resolve the split with a



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decision expected in the Summer 2012. The Supreme Court will not be treating the administrative exemption's applicability to pharmaceutical sales representatives.

<sup>30</sup> Chad Bray, *Novartis Settles U.S. Overtime Case*, THE WALL STREET JOURNAL ONLINE, Jan. 25, 2012; *see also* In re Novartis Wage & Hour Litig. No. 06-MD-1794, Order Preliminarily Approving Settlement (S.D.N.Y. Jan. 25, 2012).

<sup>31</sup> *Renfro v. Indiana Michigan Power Co.*, 497 F.3d 573 (6th Cir. 2007); *Renfro v. Indiana Michigan Power Co.*, 370 F.3d 512 (6th Cir. 2004).

<sup>32</sup> *Renfro*, 370 F.3d at 519.

<sup>33</sup> *Renfro*, 497 F.3d at 577.

<sup>34</sup> *See, e.g.*, *Baum v. Astrazeneca LP*, 372 Fed. App'x 246, 249 (3d Cir. 2010); *but see* In re Novartis Wage and Hour Litigation, 611 F.3d 141, 156-57 (2d Cir. 2010).

<sup>35</sup> 29 C.F.R. § 541.2 (2003).

<sup>36</sup> 29 C.F.R. § 541.200(a)(3) (2011); 29 C.F.R. § 541.301(b) (2011). Employers should be aware, however, that this lower "include" standard does not apply in all states. California, for example, has not adopted the amendments made by the DOL in 2004. As a result, to be exempt, California employees must still "customarily and regularly" exercise discretion and independent judgment. *See, e.g.*, Cal. Code Regs., tit. 8, § 11040, subd. 1(A)(2).

<sup>37</sup> 29 C.F.R. § 541.202(b).

<sup>38</sup> 29 C.F.R. § 541.202(a).

<sup>39</sup> 29 C.F.R. § 541.202(c).