New Rules For Commission-Paid Employees Take Effect January 1, 2013

Insights
1.02.13

(California Wage/Hour Update, No. 1, January 2013)
Effective January 1, 2013, a new California law requires that employees entering into employment agreements which involve compensation, even in part, on a "commission" basis must be provided a written contract which sets forth the method by which the commission is computed and paid. Employers must provide the employee with a signed copy of the commission agreement and obtain a signed acknowledgment of receipt of the copy. We first reported on this in a Legal Alert, which you can access here.

This law does not change, and should not be confused with, the Wage Theft Prevention Act (WTPA), a law in effect since January 1, 2012, which requires that employers provide non-exempt employees with a notice regarding the essential terms of their employment, including a section stating the basis for their compensation, e.g. whether it's payment by the hour, piece, commission, or other basis. But, far more than a summary notice requirement, the new law, (referred to as AB1396) focuses only on enhanced requirements for agreements involving commissions.

Does It Apply To Your Employees?
Not all payments labeled as "commissions" are covered by this new law. Rather, the payment, by whatever label, must fall within California's legal definition for a commission. This is found in the Labor Code and includes any payment for services rendered in the sale of the employer's goods or services that is based "proportionately" on the *amount or value* of the sale, whether the agreement involves units sold, the sales price, or on the profit made on the sale.

Although AB1396 lacks detailed guidance, it does explain that short-term productivity bonuses paid to retail clerks or other similarly employed individuals do not qualify as "commissions." Temporary, variable-incentive payments (sometimes known as "spiffs") that increase, but do not decrease, payment due to an employee do not meet the definition. Finally, bonus and profit-sharing plans are not covered unless they involve payment to the employee of a fixed percentage of sales or profits for work performed.

Bringing Your Commission Agreements Into Compliance
It is not clear whether AB1396 requires employers to implement written agreements with employees currently having only unwritten or verbal commission agreements, or whether

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employers who use written commission agreements, but have no signed receipts for them, must obtain receipts by January 1. The more cautious approach is to obtain conforming written agreements and receipts by the first of the year. Of course, if the terms of a commission agreement are changed in any way after January 1, 2013, this law's requirements will have to be met.

The Basic Requirements For Your Commission Agreements

Whether commission plans are simple or complex, it will be important to make sure all essential elements of the commission plan are articulated in the commission agreement. When writing a commission agreement, three provisions are particularly important.

First, the method of computing the commission must be described completely. The employer must define the commissionable basis, whether the commission is based on revenue or a margin of revenue, profit, or another basis. For example, employers must disclose the following:

- any applicable costs, adjustment factors, or accounting stages relevant to the commissionable basis;
- whether a portion of the revenue is excluded from the commissionable basis (such as reserved gross profit or "packs" in automobile sales transactions);
- whether the commissionable amount is based on the amount invoiced, the amount shipped, or the amount collected;
- how "profit" is defined, if a commission is based on the employer's profit;
- all internal costs assessed against a sale to determine its profit;
- whether commissions are advanced subject to chargebacks for returned items; and
- whether the commission is a fixed amount not subject to a formula (e.g., a per unit sold commission).

Second, the agreement must be clear as to when the commission is "earned," so that the employee's entitlement to commissions upon termination of employment is clear. For example, is the commission deemed earned when the sale is booked, when the product is shipped or delivered, or when payment is received for the product? These factors must be disclosed. Many commission disputes involve employees contending that they are owed commissions when one of these stages in the sales process has not occurred.

Agreements which have omitted mention of when the commission is earned, may well expose an employer to potential liability if commissions are withheld after the point of sale but before one of the above events has occurred. Indeed, ambiguous agreements are generally interpreted in favor of the employee.

Another hotspot for litigation will be what commission, if any, is due upon termination when some but not all of the requirements for earning a commission have been satisfied. For example, if the agreement is ambiguous or silent regarding how commissions are paid upon termination, courts may simply conclude that procuring the sale will alone suffice for earning the commission at the

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may simply conclude that procuring the sale will alone suffice for earning the commission at the time of termination. Don't get caught in this trap, and carefully draft your agreements to define how the commissions will be paid both during employment and upon termination of employment.

If post-sale conditions are carefully defined for earning a commission, such as an obligation for the salesperson to service the account until the product is shipped or the invoice is paid, employers will have some flexibility regarding how much of a commission will be paid for sales not yet completed when employment terminates, but again, the terms must be clearly explained.

Third, the agreement should explain how draws will be applied to commissions. For example, if the schedule for reconciliation or settlement of commissions is less frequent than the employee's regular pay period, you may be required to pay a draw so that minimum compensation requirements are satisfied. If there is a formula for calculating the draw, it should be disclosed; otherwise, the amount of the draw, if fixed, should be specified.

If the employee is subject to the inside sales exemption (available under Wage Orders 4 and 7), the draw should be an amount to exceed 1.5 times the state minimum wage (currently $8.00 x 1.5 = $12.00) in order to preserve the exemption through the settlement or measuring period for the commission.

If commissions are not sufficient to cover the draw, you must disclose whether the draw is a guarantee that will be forgiven if it is not met, or if that excess "unmet" amount will be carried forward to future reconciliation periods (e.g., after the minimum wage, if applicable, has been satisfied).

If the agreement is silent on recovery of unmet draws, then the draws generally will be deemed to be part of the employee's base pay that will not be recoverable in subsequent reconciliation periods or upon termination.

The agreement also should state the period for which commissions will be calculated (e.g., monthly), when draws are paid (e.g., weekly, semi-monthly, etc., if applicable), and when commissions will be reconciled and paid.

Provisions Not Required, But Recommended

The new law addressing commission agreements provides an opportunity to improve or clarify compensation plans in other respects. Here are some we suggest:

1. Exemption requirements may or may not impact how you draft your pay plans. In California, salaried exempt employees and outside salespersons (those spending more than half their working time out of the office making sales) are exempt from minimum wage, overtime, timekeeping, and meal and rest period requirements. If these exemptions apply, the elements should be referenced in the commission agreement.

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By contrast, *inside* salespersons are exempt from overtime in narrowly defined industries or occupations[1] when more than half of their pay is in the form of commissions and their regular rate of pay exceeds one and one-half times the minimum wage, but unlike outside salespersons, *inside* salespersons are not exempt from timekeeping or meal and rest period requirements even when they are exempt from overtime in some businesses. Therefore, for inside sales employees the agreement should include language stating that the employee will be required to keep an accurate time record and will be provided with required meal and rest breaks.

2. Commission agreements should adequately define other types of payments that could be earned, such as bonuses or other incentives, and the conditions for earning those payments.

3. The commission agreement could also include provisions regarding vacation or holidays, and special provisions regarding perks such as automobile allowances (beyond what is required by law for expense reimbursable travel) or club memberships.

4. The commission agreement should include reference to dispute resolution such as arbitration agreements that may have been signed by the employee.

5. Any written commission agreement should contain employment-at-will language reaffirming that either the employer or employee may terminate the employment relationship at any time for any reason, with or without prior notice.

Action Needed

This new law took effect on January 1, 2013. If you have commission-paid employees, you should determine whether you are in compliance with this law, and whether additional provisions should be added to your existing agreements to safeguard against employee complaints regarding compensation.

At the very least, you must comply with the requirements of this new law with respect to commission-paid employees who are hired this new year, or for employees whose pay plans will change this new year.

For more information contact the author at JSkousen@laborlawyers.com or (949)851-2424.

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[1] The inside sales exemption applies only to Wage Order 4 (technical, professional) and Wage Order 7 (mercantile). That means that inside salespersons for manufacturing companies (Wage Order 1), personal-service businesses (Wage Order 2), hotels and hospitality businesses, (Wage Order 5), and transportation businesses (Wage Order 9) are not exempt. Overtime must be paid to inside salespersons in these industries, and commissions paid must be taken into account in determining the employee's "regular rate" from which overtime is calculated.

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