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COMMENTARY

When Is a Commissioned Salesperson Exempt from Overtime in California?

California Supreme Court Holds That Commissions Cannot Be Allocated to Pay Periods in Which They Are Earned

California and federal law establish different requirements for the so-called "commissioned employee" overtime exemption. This exemption allows many California employers to avoid paying overtime compensation to some commissioned employees. On July 14, the California Supreme Court issued its decision in *Peabody v. Time Warner Cable, Inc.,* Case No. S204804 (July 14, 2014), which begins to define the contours of the California exemption. As will be discussed in the paragraphs that follow, *Peabody* will require employers to monitor the earnings of such employees every pay period. An employee could be exempt under the "commissioned employee" exception in one pay period and non-exempt in the next pay period. For pay periods in which these employees are not exempt, the employees must be paid overtime in accordance with California law. Further, employers must maintain time records on commissioned employees as those employees are exempt only from overtime requirements and not from meal/rest period or other requirements for non-exempt employees.

The *Peabody* decision applies only to "inside" sales personnel; it does not address or affect the "outside sales" exemption for employees who work more than 50 percent of their time away from the employer's premises and engage in selling and closely related sales activities.

Under section 7(i) of the Fair Labor Standards Act, commissioned employees working for retail or service establishments need not be paid overtime if: (i) the employee's regular rate of pay exceeds one and one-half times the applicable minimum wage for every hour worked in a workweek in which overtime hours are worked; and (ii) more than half the employee's total earnings in a representative period must consist of commissions. *See* 29 C.F.R. § 779.412. To satisfy the first of these tests, "[t]he employee's 'regular rate' of pay must be computed … on the basis of his hours of work in that particular workweek and the employee's compensation attributable to such hours." *Id*. § 7779.419(b). Whether compensation representing commissions constitutes most of an employee's pay under the second test "must be determined by testing the employee's compensation for a 'representative period' of not less than 1 month," as long as the chosen period "typifies the total characteristics of an employee's earning pattern in his current employment situation, with respect to the fluctuations of the proportion of his commission earnings to his total compensation." *Id*. § 779.417(a).

It likely comes as no surprise to learn that California law is different. Rather than limit the commissioned employee exemption to the retail and service sectors, California's Wage Orders create a commissioned employee exemption for workers in the mercantile (i.e., retail) industry governed by Wage Order No. 7, as well as to workers who work in "professional, technical, clerical, mechanical and similar occupations" governed by Wage Order No. 4. However, many employers who utilize commissioned sales for marketing personnel are *not* subject to either Wage Order No. 4 or 7. For example restaurants, hotels, resorts, and health clubs all utilize sales or marketing employees who are frequently paid on a commissioned basis, but none of those employers is subject to either Wage Order No. 4 or 7.

Like federal law, the Wage Orders generally provide that commissioned employees need not be paid overtime if: (i) their "earnings exceed one and one-half times the minimum wage" and (ii) "more than half of that employee's compensation represents commissions" Cal. Code Regs., tit. 8 §§ 11040(3)(D) & 11070(3)(D) (Wage Order Nos. 4 and 7, Section 3D). However, the Wage Orders do not create a "representative period" test, and they provide little if any guidance as to how to determine whether and under what circumstances the employee's "earnings exceed one and one-half times the minimum wage" under state law.

The California Supreme Court provided some guidance with respect to these issues in *Peabody v. Time Warner Cable, Inc.* The California Supreme Court held that, to determine if the employee's "earnings exceed one and one-half times the minimum wage," the employer must actually *pay* sufficient wages (base pay and/or commissions) *each* pay period, in order for the exemption to apply. This will render the exemption much less useful where an employer accrues commissions over a period of one month or longer but pays the commissions only at the end of the accrual period.

In *Peabody*, Time Warner employed Susan Peabody as an account executive who sold advertising on the company's cable television channels. The company paid Peabody straight hourly wages on a biweekly basis but calculated and paid Peabody's commissions on a monthly basis. The company acknowledged that most of Peabody's paychecks included only hourly wages at a rate that was *less than* one and one-half times the minimum wage. However, the company claimed that Peabody nonetheless qualified for the commissioned employee exemption under Wage Order 4 because her commission earnings "should be reassigned from the biweekly pay periods in which they were paid to earlier pay periods" in which they were earned.

The California Supreme Court evaluated Time Warner's arguments pursuant to the traditional rules that California's overtime requirements "are to be construed broadly in favor of protecting employees," while overtime exemptions are to be "narrowly construed against employers. The court then held that an employer may *not* attribute commission wages paid in one pay period to other pay periods in order to satisfy commissioned employee overtime exemption, for three related reasons.

First, the California Supreme Court explained that California Labor Code section 204(a) generally provides that wages "are due and payable twice during each calendar month," and that this requirement applied to commission wages. The court recognized that employers do *not* have an obligation to pay *unearned* commission wages in any particular pay period and that "commissions are owed only when they have been earned, even if it is on a monthly, quarterly, or less frequent basis." However, the court emphasized that commissions are payable in the semimonthly pay period in which they are earned.

Second, the California Supreme Court rejected the notion that commissions paid in one pay period can be attributed to another pay period. The court held that, "[w]hether the minimum earnings prong is satisfied depends on the amount of wages *actually paid* in a pay period," and that employers "may not attribute wages paid in one pay period to a prior pay period to cure a shortfall." The court rationalized its holding in part by explaining that "[m]aking employers actually pay the required minimum amount of wages in each pay period mitigates the burden imposed by exempting employees from receiving overtime. This purpose would be defeated if an employer could simply pay the minimum wage for all work performed, including excess labor, and then reassign commission wages paid weeks or months later in order to satisfy the exemption's minimum earnings prong."

Third, the California Supreme Court rejected Time Warner's suggestion that the commissioned employee overtime exemption created by California's Wage Orders should be interpreted consistently with the commissioned overtime exemption recognized by section 7(i) of the Fair Labor Standards Act ("FLSA"), finding that the two laws were "substantially different" in several respects.

The California Supreme Court then summarized its holding by adopting the following three somewhat overlapping tests adopted by the Division of Labor Standards Enforcement to determine whether an employee can qualify for California's commissioned employee overtime exemption:

1. The employee's earnings must exceed 1.5 times the minimum wage for each hour worked during the pay period.
2. The payment of the earnings of more than 1.5 times the minimum wage must be made in each pay period. Therefore, it is not permissible to defer any part of commissions due for one period until a later period so that the later period qualifies for exemption.
3. Compliance with the requirements of the exemption is determined on a workweek basis. *The minimum compensation component of the exemption must be satisfied in each workweek and paid in each pay period.*

Peabody's holding is consistent with the enforcement policies of California's Division of Labor Standards Enforcement. Nonetheless, the California Supreme Court's decision puts into question the payroll practices of many retail and similar employers, who have long attributed commissions over a period of greater than a single pay period. Hence, in order to comply with *Peabody*, California employers would be well advised to consider at least the following issues:

Employers must consider whether commissioned employees qualify for exemption under *both* federal and state law. As the *Peabody* court noted, the commissioned employee overtime exemption recognized under the FLSA differs from the similar exemption recognized under California law. Commissioned employees must satisfy the tests laws before they would be entirely exempt from overtime pay. The federal exemption is available *only* to employees and employers in true retail settings.

- Employees whose commission earnings are uneven or fluctuate widely could be exempt in one pay period and not exempt in the next. Therefore, the employer will have to determine if each employee is exempt on a pay-period-by-pay-period basis, and they will have to pay overtime under the California overtime rules for pay periods in which the employee does satisfy the elements of exemption. This is a particularly important consideration, given that the state minimum wage has recently increased to $9.00 per hour and is scheduled to increase to $10.00 effective January 1, 2016.
- Because commissioned employees might be non-exempt in some (or most) pay periods, employers must keep time records for these individuals as if they were non-exempt employees. Additionally, employers must provide, and maintain records regarding provision of, meal and rest periods for these employees at least in those pay periods in which the exemption is not satisfied. It may be difficult to comply with this rule as a practical matter given that the amount of commission wages may not be accurately calculated in advance.
- Faced with the burden of determining whether each of its potentially numerous sales employees qualify for exemption on a pay-period-by-pay-period basis, some employers might opt for a simpler system. This could include paying employees a lower commission percentage or element and then making up the difference with overtime premiums for hours for which such premiums are required.
- The California Supreme Court's opinion does not address the second prong of the exemption: that more than one-half of the employee's compensation in each pay period be in the form of commissions. This requirement has, in some industries, rendered the exemption less useful. The employee's "draw" or guaranteed hourly rate must be low enough so that, in all pay periods, commissions represent more than one-half of the total earnings (which must in turn amount to more than one and one-half times the minimum wage). Therefore, the commissioned employee exemption is most helpful where the employee is substantially dependent on commission earnings. Some employers believe that higher "draws" or guarantees are effective incentives to obtain better or more loyal employees. Unfortunately, while that observation may be true, it makes the commissioned employee exemption more difficult to achieve.

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