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Management Alert

Court Of Appeal Confirms Employer Right to Recover Advanced Commissions

The First District Court of Appeal clarified that an employer with a properly crafted commission agreement can recover commission payments already advanced to employees for commissions the employee did not earn. Here, four former employees filed a class action alleging their compensation plans (that offset unearned commissions against current payments) violated various provisions of the Labor Code. After a court trial, the trial judge ruled in favor of the employer on both the complaint and its cross complaint (for uncollected chargebacks). In *Koehl, et al. v. Verio, Inc.*, the Court of Appeal in San Francisco upheld the trial court determination that the compensation plans did not violate the Labor Code.

The Case

The plaintiffs in this case were former sales associates who earned a base salary between $40,000 and $70,000. They also were paid commissions for selling various internet services to prospective customers. The compensation plans at issue provided that commissions would be paid when an order was booked, but allowed the employer to recover or charge back the commissions if certain conditions for completing the sale were not met.

When a sales associate "booked" an order it merely was an administrative step necessary to make certain that an order form was completed. The sales associate would receive a commission payment at the time the order was booked. After the sale was booked, sales associates had significant ongoing responsibilities with the customers, including acting as a contact point, directing them to others for technical and billing questions, and serving as problem solvers. Commissions on these sales were not "earned" until the sale was considered complete.

Compensation for sales associates was based on various compensation plans between 1999 and 2002 each with their own definitions of "complete sale." The 1999 plan created the right to impose a chargeback on all accounts canceled within 270 days of activation, and any such chargebacks were treated as a "reduction in

revenue credit" for the employee in the month following the account cancellation. The 2000 plan stated that the employer was paying commission in some instances prior to when the commission was actually earned, which was defined as after the service or product was delivered, accepted and payment has been made. The 2000 compensation plan stated that the company had the right to seek reimbursement for any commission paid for any account canceled prior to billing, and up to 90 days after activation of service. The 2001 plan was more specific, stating that "commissions are not earned until after three (3) months of Monthly Recurring Revenue payments have been received." The 2001 plan also stated that commissions were paid before they were actually earned. The terms of the 2002 plan were similar to the 2001 plan.

Sales associates reviewed and signed their commission plans, authorizing the chargebacks to be deducted from future paychecks. In their testimony at trial, the plaintiffs admitted they understood the terms of the compensation plans, and that their commission payments were advances which could be reduced if the accounts canceled within three months. Significantly, the employer always charged back commissions from sales associates' commissions, never from their base pay.

Advance Commission Payments Are Not "Wages"

The former employees claimed the chargebacks violated Labor Code section 221, which states that "[it is] unlawful for an employer to collect or receive from an employee any part of wages theretofore paid by said employer to any said employee." The Court of Appeal disagreed, finding that the commission advances paid were not "wages."

The Court explained that the right of a salesperson or any other person to a commission depended on the terms of the contract for compensation, relying on the decision in *Steinhebel v. Los Angeles Times Communications, LLC* (2005) 126 Cal.App.4th 696, 705. The *Verio* Court held that it was "clearly the law" in California that a salesperson must pay back the excess of advances made over commissions earned when there is an express agreement on the part of the salesperson to do so. In *Steinhebel*, the court upheld a compensation plan where telesales employees received advances on commissions which could be charged back if a customer did not keep a newspaper subscription for 28 days. Even though the plan did not use the term "advances" to describe the commission payments, the Court held that the payments were indeed "advances." It was sufficient that the compensation plans expressly and clearly stated that the commissions were not earned at the time of sale. The Court also expressly rejected the argument that the chargebacks improperly shifted the cost of doing business to the employees.

Chargebacks Are Permitted Even If the Commission Payments Are Wages

The Court of Appeal went one step further in finding the compensation plan legal, holding that Labor Code section 224 provided an independent basis to allow chargebacks in certain situations. Section 224 states that an employer "may withhold or divert any portion of an employee's wages when . . . a deduction is expressly authorized in writing by the employee to cover . . . deductions not amounting to a rebate or deduction from the standard wage. . ." The Court held that, even if advance payments were considered "wages," an employer may withhold or divert them if the deduction is: (1) authorized in writing;

and (2) does not reduce the employee's "standard wage." Not finding any definition for "standard wage," the Court determined that common usage of the term refers to an employee's base pay. Since there existed a written agreement with Verio's employees, and since the chargebacks did not reduce the employees' base pay, they were authorized under Labor Code section 224.

What *Verio* Means for Employers

Between *Steinhebel* and *Verio*, it is now clear that commission plan that includes a mechanism for chargebacks for recovering unearned commissions can be created and enforced. After *Verio*, employers may lawfully chargeback or recover advances on commissions if: (1) the employee at issue has reviewed and acknowledged the plan in writing; and (2) the compensation plan clearly provides that the commission advanced is not actually "earned" until some condition subsequent to the advance payment is satisfied. An additional layer of protection can be obtained by seeing to it that adjustments a re made solely to the commission paid and unearned commissions are not recouped from base salary.

It also remains evident that the devil is in the detail on so-called chargeback programs. The key is in sound drafting, communication and precision in execution of the plan. In particular, although in this case the payment (against which future charges was made) was not labeled an "advance", preferred practice remains to do so and avoid a court empowering a court inclined to find ambiguity from reaching a bad result.

If you have any questions regarding the Verio ruling, please contact the Seyfarth Shaw attorney with whom you work, or any of the Labor & Employment attorneys on our website, www.seyfarth.com.

ATLANTA
One Peachtree Pointe
1545 Peachtree Street, N.E.
Suite 700
Atlanta, GA 30309-2401
404-885-1500
404-892-7056 fax

BOSTON
World Trade Center East
Two Seaport Lane
Suite 300
Boston, MA 02210-2028
617-946-4800
617-946-4801 fax

CHICAGO
131 S. Dearborn Street
Suite 2400
Chicago, IL 60603-5577
312-460-5000
312-460-7000 fax

HOUSTON
700 Louisiana Street
Suite 3700
Houston, TX 77002-2797
713-225-2300
713-225-2340 fax

LOS ANGELES
One Century Plaza, Suite 3300
2029 Century Park East
Los Angeles, CA 90067-3063
310-277-7200
310-201-5219 fax

NEW YORK
1270 Avenue of the Americas
Suite 2500
New York, NY 10020-1801
212-218-5500
212-218-5526 fax

SACRAMENTO
400 Capitol Mall
Suite 2350
Sacramento, CA 95814-4428
916-448-0159
916-558-4839 fax

SAN FRANCISCO
560 Mission Street
Suite 3100
San Francisco, CA 94105-2930
415-397-2823
415-397-8549 fax

WASHINGTON, D.C.
815 Connecticut Avenue, N.W.
Suite 500
Washington, D.C. 20006-4004
202-463-2400
202-828-5393 fax

BRUSSELS
Boulevard du Souverain 280
1160 Brussels, Belgium
(32) (2) 647 60 25
(32) (2) 640 70 71 fax

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