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COMMISSIONS, INCENTIVE PAYMENTS AND BONUSES UNDER CALIFORNIA LAW

Overview

Commissions, incentive payments and bonuses present special problems under California law. A majority of employers (and lawyers) are unaware of them. The reason is that there has been little litigation over these issues, *as yet*. For the same reason, there are often no judicial precedents or guidelines.

The analyses and recommendations in this White Paper are based, in a number of instances, on our best prediction as to how courts are likely to rule. In places, our recommendations are moderately conservative. We would be more aggressive if a client were confronted with a lawsuit, but one of the objectives of counseling is to avoid litigation.

A. How Frequently Must Employees Be Paid, And On What Day Or Date?

1. Regular Payroll For On-Going Employees

California requires that all *earned* compensation must be paid *at least semi-monthly (twice per month) on a regular payday*. The regular payday may be no later than the 26th of the month for the first half of the month (1st through 15th) and no later than the 10th of the following month for the second half of the month (16th through the last day of the month). Pay periods may be *shorter* than semimonthly, i.e., weekly or bi-weekly, in which case, there must be a regular payday occurring no later than seven calendar days following the close of the payroll period.

There are no exceptions for commission, incentive or bonus methods of compensation.

Exempt executive, administrative and professional employees may be paid *once* per month, no later than the 26th of the month, but this exception is *not* available to other personnel, not even to other exempt personnel such as outside salespersons or commission-compensated personnel.

Overtime may be delayed one payroll period.

The question of when compensation is *"earned"* is *the* major and difficult question. It is partially subject to practicalities of the business and partially subject to judicial interpretation. It may require minute analysis of the compensation plan. In the event of legal challenges, arbitrary, artificial or unreasonable delays in recognizing "earned" compensation are likely to be rejected by the courts.

For example, a plan that does not recognize compensation as "earned" until payment has been received from the customer is likely to be upheld, if challenged in court, but a plan that does not recognize compensation as "earned" until the close of a quarter is more likely to be held unlawful.

In the case of plans that calculate compensation based on performance over an extended period, e.g., monthly, quarterly or annually, arguably compensation is not "earned" until the period ends and the required data is collected, but, again, arbitrary or merely convenient delays in data collection, calculation and payment are likely to be rejected by the courts.

Once a commission, incentive payment or bonus is properly deemed "earned," it should be paid on the regular payday for the payroll period in which it was finally earned.

For example, if compensation is paid semi-monthly on the 10th and 26th, then commissions, incentive payments and bonuses determined to have been finally "earned" within the first 15 days of the month should be paid on the 26th, and commissions, incentive payments and bonuses determined to have been finally earned within the period from the 16th through the final day of the month should be paid on the 10th of the following month.

2. Accelerated Payroll For Terminating Employees.

Terminating employees must be paid *immediately* upon termination or, in the case of quitting employees who give less than 72 hours notice, within 72 hours of quitting. It is not permissible to wait until the next payday.

There are no exceptions for exempt personnel of any kind.

In the case of involuntarily terminated employees (discharged or laid off), this requirement explicitly applies to compensation that has been earned. The statute for quitting employees is less clear, but arguably it too applies to compensation that has been earned.

Determining when a terminating employee's commission, incentive payment or bonus has been "earned" is the same difficult question that arises in connection with regular payroll for on-going employees.

Logically, a payment may be delayed *past termination*, if it was not *earned* at the time of termination, but it should be paid immediately, once finally earned, without waiting for the next payday[1].

For example, if commission compensation is considered "earned" when payment is received from the customer, and if a sales representative terminates after making a sale, but before the company's receipt of payment, logically the company is not obligated to pay a commission at the time of termination, but the company must pay the commission *immediately* upon receipt of payment.

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[1] These conclusions are examples of ones made without benefit of any precedent or guideline.

B. What May Be Charged Against Employees For Purposes Of Calculating Commissions, Incentive Payments And Bonuses?

Generally, reductions in sales attributable to other sales representatives may not be charged against a sales representative, only reductions in sales attributable to the sales representative's own accounts.

Generally, cash shortages, breakage or loss of equipment may not be charged against employees, unless it was caused by the employee's dishonesty, willfulness or gross negligence. Exempt executive, administrative, professional, and outside sales employees are excepted from this rule[2]. Other exempt employees are not excepted. The effect is that normal cash shortages, breakage and loss of equipment may not be taken into account in incentive or bonus plans to the extent those plans are applicable to employees who are *not* exempt executive, administrative, professional or outside sales employees.

Workers' compensation expenses may not be taken into account in calculating any payment. This is particularly troublesome when payments are based on profits. Workers compensation expenses must be backed out of the calculation for profits.

These onerous rules could change, depending on the ruling of the California Supreme Court in a case that has been pending before the Court for more than a year, but that is now set to be argued on June 6, 2007: *Prachasaisoradej v. Ralphs Grocery*.

C. What Payments May Be Taken Back From Employees After They Have Been Paid? Advances.

Generally, California prohibits an employer from taking back any part of an employee's compensation already paid to the employee. This problem may be partially ameliorated by characterizing some payments as "advances" against compensation to be earned later. The rationale is that advances are not compensation, because they have not yet been earned. For example, a commission compensation plan might provide that commissions are not earned until payment has been received from the customer, but might also provide for advances to be paid before payment is received from the customer. If it later turns out that the advances are not going to be earned, because, for example, a customer cancels an order, taking back the advance is lawful. It was not compensation in the first place.

Generally, California also prohibits an employer from unilaterally deducting employee debt from an employee's paycheck. This prohibition applies to any and all kinds of employee debt, including debt arising from overpayment, regardless of whether the overpayment was caused by error or by cancellation of sales on which the payment had been made. Arguably, however, when advances have been paid, they may be regarded as credits to the employer against future earned

[2] Outside sales employees are excepted from this rule, even though they are not excepted from the rules on frequency and date of payroll.

compensation. The rationale is that, once compensation has been earned, treating the advance as a credit against the earned compensation, i.e., as a portion that has already been paid, is not the same as deducting a debt.

While utilizing the concept of advances may be useful, it also introduces additional complexity into the compensation scheme.

D. What Payments May Be Denied Terminating Employees?

Denying payment altogether is different from *delaying* it. As to *delaying* payment, see the discussions under heading A, above. Generally, care should be taken not to write plans so as to deny payments to terminating employees arbitrarily. On the other hand, payment may be denied when there is a rational basis for it. Pique at employees for leaving is not a rational basis.

When a sales representative terminates without having completed all the work expected of the sales representative with regard to a particular sale, it is probably defensible to *apportion* the corresponding compensation on a rational basis, but it is legally risky to cut it off completely.

When a compensation arrangement imposes both *burdens* and *benefits* on terminating sales representatives, courts will probably uphold the arrangement. For example: cutting-off commissions, but forgiving advances; or cutting-off commissions, but paying severance. Balancing of this nature must be written into the compensation plan. It may not be improvised at the time of termination. When a compensation arrangement imposes *burdens only* on a terminating sales representative (for example, cutting off commissions), who has done everything required before termination, and provides *no benefit*, it is likely that the courts will not uphold the arrangement.

In the case of plans that calculate compensation based on performance over an extended period, e.g., monthly, quarterly or annually, as incentive plans typically do, the plan should be closely analyzed to determine whether qualifying for payment under the plan is, as a matter of fact, not possible without an employee's completing the period, or whether qualifying can, in fact, occur mid-period as well. In the former case, it is likely safe to deny payment to an employee who terminates before completion of the period. In the latter case, it is likely not.

When retention of personnel is a plan objective, a plan that requires an employee to remain employed through completion of a period of time is probably defensible.

E. How Should Additional Overtime Be Calculated?

When non-exempt personnel are paid commissions, incentive payments or bonuses, additional overtime *must* be paid for those workweeks covered by the payment *and* in which the employee worked in excess of 8 hours per day or 40 hours per week.

These rules are inapplicable to any employee exempt from payment of overtime, including executive, administrative and professional employees, outside salespersons, and certain commission-compensated employees. There is, however, no exemption for sales per se.

These rules are inapplicable to *discretionary* bonuses, i.e., bonus payments not promised in advance, but genuinely discretionary bonuses are exceedingly rare.

The overtime may be calculated based solely on the commission, incentive payment or bonus without taking into account overtime paid on other forms of compensation: Divide the commission, incentive payment or bonus by total hours worked (straight-time hours and overtime hours) during the period to which the payment is applicable (month, quarter, year) to produce an effective straight-time hourly rate based on that payment for that period. Pay an additional half the effective straight-time hourly rate for each hour entitled to time-and-a-half during the period. Pay an additional full effective straight-time rate for each hour entitled to double-time during the period.

California rules in this regard are similar to the law under the federal Fair Labor Standards Act (FLSA). Therefore, the same rules expressed here under California law are also applicable across the country under the FLSA, except that the FSLA requires overtime only for time worked in excess of 40 hours per week. The FLSA does not require any daily overtime or double-time.

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