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California Supreme Court Ruling Restricts Employers in Calculating and Paying Commissions

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In an important decision that is sure to lead to more wage-and-hour class actions, the California Supreme Court unanimously ruled in *Peabody v. Time Warner Cable, Inc.,* that an employer's practice of paying commission wages at the end of each month, for the commissions earned in the prior month, fails to satisfy the "commissioned sales exemption" from overtime and could also violate other provisions of California wage-and-hour law.

The Supreme Court summarized its holding in a single sentence: Employers may not "attribute commission wages paid in one pay period to other pay periods in order to satisfy California's compensation requirements."

Although the decision primarily addressed the proper scope of the commissioned sales exemption – and interpreted that exemption very narrowly – it potentially affects *all* employers in California who maintain commission systems, whether or not they rely on the exemption, because it provides new guidance on how frequently all commissions must be paid. Specifically, once commissions are earned, employers must pay them out to employees *at least twice a month*. Employers can no longer wait to pay them on a monthly or quarterly basis.

Time Warner's Commission System

Time Warner employed "account executives" to sell advertising on its cable television channels. It paid the account executives a base salary and commissions.

The plaintiff, Susan Peabody, worked as an account executive for about 10 months. She and the other account executives were paid biweekly. In every biweekly paycheck Peabody received $769.23 in base wages, the pro rata portion of an annualized salary of $20,000. Assuming a 40-hour workweek, this equated to $9.61 per hour.

Under Time Warner's commission plan, employees earned a commission on a sale only when the following three conditions were met: 1) the order had been procured from the customer, 2) the advertising had been broadcast, and 3) the revenue from the sale had been collected from the client.

Time Warner paid the commissions monthly in the last biweekly paycheck of each calendar month. It paid the commissions one month in arrears. Thus, for example, the commissions paid in a November paycheck compensated for any commissions the employee earned in October.

Peabody claimed, and Time Warner did not dispute, that she typically worked 45 or more hours per week, and sometimes more than 48 hours. Time Warner did not pay overtime to Peabody or the other account executives, because it classified them as exempt under California's "commissioned sales" exemption.

The Commissioned Sales Exemption

The commissioned sales exemption in California is sometimes referred to as the "inside" sales exemption to distinguish it from the separate “outside” sales exemption. The commissioned sales exemption is available only to employees employed under Wage Orders 4 (office, professional, technical and other similar employees) and 7 (retail employees). It is an exemption only from California’s *overtime* requirements, not from minimum wage or any of the other requirements in the Wage Orders applicable to non-exempt employees generally.

To satisfy the exemption, (1) an employee's earnings must exceed one and-one-half times the California minimum wage, and (2) more than half of the employee's compensation must consist of commissions rather than other forms of pay. I.W.C. Wage Order 4-2001 at Section 3(D), Cal. Code Regs. tit.8, § 11040 3(D).

This exemption resembles the federal retail sales exemption found in the Fair Labor Standards Act at Section 7(i). However, the FLSA exemption narrowly applies only to certain “retail and service establishments,” as very narrowly defined in the Department of Labor’s regulations. *Peabody* addressed only the California version of the exemption, and it interpreted only the first prong of the exemption: the requirement that an employee’s earnings exceed one and one-half times the minimum wage. This equated to $12 per hour at the times relevant to the *Peabody* case, but is now $13.50 due to the recent increase in California's minimum wage to $9 per hour.

Peabody’s Lawsuit

Peabody filed a class action lawsuit against Time Warner alleging claims under California law for unpaid overtime, minimum wage, failure to pay all wages due at termination, and violation of California’s pay stub law. All of her claims revolved around the way Time Warner paid commissions.

Peabody argued that she and the other account executives were misclassified as exempt under the commissioned sales exemption. She argued that for the pay periods in which she received only her base pay ($769.23), she received less than $12 an hour for each hour worked, because that amount, by itself, was only enough to cover about 32 hours a week at $12 per hour, and she worked more than 32 hours.

Time Warner countered that her commission payments, although paid in only one paycheck per month, were based on the commissions she earned over an entire month. It argued that in determining whether Peabody received at least $12 for all hours worked, the commissions should be apportioned over the period of time in which they were earned: the entire month. Under Time Warner’s interpretation, the account executives were paid more than $12 for each hour worked, because the commission amounts, combined with the base pay, always exceeded the $12 threshold.

The federal district court agreed with Time Warner and granted summary judgment in the company's favor. On appeal, the Ninth Circuit punted the issue to the California Supreme Court, because it could find no California authority addressing this apportionment issue. The Supreme Court agreed to decide the issue, and it has now ruled, siding with Peabody.

<u>The Labor Code Prohibits Employers from Using a Monthly or Less Frequent Pay Period for Earned Commissions</u>

The Supreme Court first addressed Time Warner's argument that commission wages should be attributed to the monthly period in which they are *earned*, rather than the pay periods in which they are *paid*. The Court was unpersuaded by this argument.

The Court first analyzed the statute that governs how frequently wages must be paid: Labor Code section 204. That section states, as a general rule, that "all wages … earned by any person in any employment are due and payable twice during each calendar month…." The Court noted that "commissions" are expressly included in the Labor Code's definition of "wages." Lab. Code § 200. It follows, according to the Court, that "all earned wages, *including commissions*, must be paid no less frequently than semimonthly." (Emphasis in original.)

The Court characterized Time Warner's commission system as one that improperly maintained a "monthly pay period" in calculating and paying commissions. The Court acknowledged, as the Division of Labor Standards Enforcement (DLSE) has stated in its opinion letters, that "commission programs which *calculate* the amount owed once a month (or less often) are common." (Emphasis in original.) However, the Court did not regard this as signifying the DLSE's approval of *monthly pay periods*. The Court agreed with the DLSE that in some instances it might be lawful for an employer to pay commission monthly, but only *if no commissions were earned* in the other semi-monthly or biweekly pay periods falling in the same month.

As an example, the Court noted that under a commission system like Time Warner's, which requires receipt of a customer's payment before the commission is earned, a customer may routinely pay its bills on the 15th day of each month. In that situation, according to the Court, commissions will be earned and owed only once a month. This is different, the Court said, than creating a "monthly pay period" in contravention of Labor Code section 204.

> To summarize, section 204 establishes semimonthly pay periods, but there is no obligation to pay *unearned* commission wages in any pay period. Commissions are owed only when they have been earned, even if it is on a monthly, quarterly, or less frequent basis.

Importantly, in discussing and deciding this issue, the Court did *not* expressly limit its analysis to the commissioned sales exemption, but rather seemed to be providing a discussion of the Labor Code's pay-timing rules generally.

<u>Employers May Not Apportion Commissions over More Than One Workweek to Satisfy the Commissioned Sales Exemption</u>

Having found that the Labor Code does not permit commissions to be paid in monthly pay periods, the Court went on to find that the first prong of the commissioned sales exemption – requiring that an employee's earnings exceed 1.5 times the minimum wage – means that employees' earnings paid *in each pay period* must meet this threshold for each workweek of the pay period. "Whether the minimum earnings prong is satisfied depends on the amount of wages *actually paid* in a pay period. An employer may not attribute wages paid in one pay period to a prior pay period to cure a shortfall." (Emphasis in original.)

The Court noted that this interpretation is consistent with the DLSE's enforcement position and also with the general principle that courts are to construe overtime exemptions narrowly for the protection of employees.

Additionally, the Court stated that "permitting wages paid in one pay period to be attributed to a different pay period would be inconsistent with several Labor Code provisions." In particular, the Court cited Section 204 (the pay-timing statute), which the Court said requires semimonthly or biweekly paychecks to include the "wages earned during that pay period." The Court also cited Section 226 (the "pay stub" law), which requires that wage statements list the gross and net wages earned, and the inclusive dates of the period for which the employee is paid. Reassigning wages in the manner suggested by Time Warner, in the Court's view, "would ignore the obligations imposed by these statutory provisions."

Noting the differences between federal and California law, the Court rejected Time Warner's argument that its pay system was supported by federal law. Unlike California, for example, the FLSA does not require that employees be paid at least twice per month, and it allows employers to average an employee's pay over a pay period in determining whether the employee received the minimum wage for each hour worked.

In summary, the Court ruled that Time Warner could rely on the commissioned sales exemption for those biweekly pay periods in which the paychecks included a commission payment together with base pay (12 of the 26 biweekly pay periods in a year), but not for the other 14 pay periods in which the paychecks included only the employee's base pay.

Finally, the Court noted in a footnote that its interpretation supported Peabody's separate minimum wage claim, depending on how many hours she worked each week. Because many of her paychecks included only base pay of $384.61 per week ($20,000/52), this would be insufficient to compensate her at $8 per hour for any week in which she worked more than 48.1 hours.

Conclusion

The Court in *Peabody* clarified (unfavorably for employers) how the first prong of the commissioned sales exemption is to be interpreted and how often commissions must be paid. However, the decision may have broader implications and raises more questions than it answers. At a minimum, *Peabody* should cause every company in California that pays employees commissions and other incentive compensation to review their incentive plans and practices.

For a further elaboration of the questions left open by *Peabody,* our predictions on the effect *Peabody* will have on our litigation climate, and our advice to employers on specific steps they should take in response to this decision, please contact Tom Geidt or the partner you work with at Grube Brown & Geidt.