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July 25, 2014

THE SECOND PRONG OF THE INSIDE SALESPERSON TEST – IS THE CALIFORNIA SUPREME COURT POISED TO UPEND THE COMMISSIONED EMPLOYEE EXEMPTION?

In *Peabody v. Time Warner Cable, Inc.*, the California Supreme Court clarified that, to satisfy the commissioned employee exemption, employees must be paid more than 1.5 times the minimum wage *in the employee's actual pay period – e.g.*, in the given bi-weekly or semi-monthly pay period. Employers cannot meet this minimum wage threshold by, for example, averaging an employee's wages over a month-long period, even if commissions are paid on a monthly basis (or less frequently).

While this ruling certainly risks the validity of the exemption for employees who have worked under commission plans in existence for years, employers know how to rectify the problem highlighted by the Court. Employers must now guarantee that their employees earn more than 1.5 times the minimum wage for each pay period, without looking to other payments from other pay periods or averaging pay periods together. In other words, each pay period must stand on its own and be looked at independently.

The implications of the ruling that have not received a lot of attention risk a much more serious problem for employers. Under the second prong of the test for the exemption, commissions must represent more than half of the employee's compensation. If *Peabody* is extended to this prong of the test, then employers will be, once again, caught off guard and will confront an entirely new set of problems with regard to satisfying the exemption.

The Commissioned Employee Exemption

At the heart of *Peabody* is the commissioned employee exemption. The exemption allows some employers to treat employees who earn all or part of their wages from commissions as exempt, but only if: (a) the employee is paid more than 1.5 times the minimum wage; and (b) more than half of the employee's compensation is from commissions. *See* **IWC Wage Order 4, at 3(D)**.

Employees Working under Commission Plans That Do Not Guarantee an Employee More than 1.5 Times the State Minimum Wage *For Each Pay Period* Are Not Exempt

The employer in *Peabody* paid the plaintiff about $9.61 per hour (assuming a 40 hour workweek) every other week, and commissions on a monthly basis. The plaintiff argued that this did not meet the test for the exemption because in pay periods when she did not receive commission payments, at least once per month, she received compensation for hours worked that was less than 1.5 times the minimum wage.

The employer argued that the employee was paid more than 1.5 times the minimum wage because the average of the employee's wages over a month-long period exceeded the minimum compensation threshold. In other words, even though the employee was paid less than 1.5 times the minimum wage for the first pay period of the month (because her first paycheck did *not* include commissions), she was paid a large amount for the second pay period of the month (because her second paycheck included her commissions). The employer's position was that the large second paycheck should be combined with the small first paycheck, and so her average hourly wage *for the month* still exceeded 1.5 times the minimum wage.

The Court in *Peabody* held that employers cannot calculate the exemption in this manner, *i.e.*, by using payments in one pay period to bolster payments in another pay period. The exemption, rather, must be calculated for each pay period and based only on compensation paid during that pay period.

The Court based its decision on: (a) its duty to narrowly construe exemptions against the employer; (b) existing Labor Code provisions that are inconsistent with the concept of permitting wages earned in one pay period to be attributed to a different pay period; and (c) guidance from the DLSE. The Court rejected the employer's reliance on federal law because California law differs in that, for example, it requires that

employees be paid at least twice per month, whereas federal law has no such requirement.

Peabody, therefore, means that employers who have implemented commission plans that pay employees less than 1.5 times the minimum wage for some pay periods may owe overtime wages for overtime hours worked during that pay period. For example, employees who have been treated as exempt but who have been earning only minimum wage plus commissions may be owed overtime wages for any pay period during which they received no commission payments.

Potential Risk from the Second Prong

Peabody addressed only the first prong of the exemption (*i.e.*, whether the employee was paid more than 1.5 times the minimum wage). The Court expressly declined to address the second prong (*i.e.*, whether the employee earned more than half of his or her compensation from commissions). And while plaintiffs' attorneys will surely scramble around to hold employers accountable for commission plans that do not comply with the first prong, employers should anticipate efforts to extend *Peabody* to the second prong.

An argument could be made that, just as a trier of fact cannot look to other pay periods to satisfy the requirement that the employee earn 1.5 times the minimum wage, a trier of fact also should not be able to look to other pay periods to satisfy the requirement that more than half of the employee's compensation is from commissions. Pay periods where no commission is paid, therefore, can be argued to fail to meet the requirement that more than half of the employee's compensation is from commissions.

The impact of such an extension would be far-reaching. First, employers' adjustments to their commission plans to remedy the 1.5 times the minimum wage problem actually identified in the *Peabody* decision would be rendered futile. These commission plans, even after being modified, would still leave employees eligible for overtime.

In addition, extending the *Peabody* rule to the second prong of the test could not be easily cured. Unlike the first prong, where 1.5 times the minimum wage can be calculated and guaranteed, the second prong is not nearly as predictable. In the first half of a month, where no commissions are paid to an employee, it is difficult to ensure that an employee receives commissions that amount to more than half of an employee's compensation. Perhaps a plaintiff would demand that an employer pay an employee a draw that exceeds the employee's other compensation. For example, if an employee earns $9 per hour and works 80 hours in one pay period ($720), then the draw must be more than $720 for that pay period.

Fortunately for employers, there are reasons to doubt that courts will extend *Peabody* to the second prong of the exemption test. First, federal law expressly frames the second prong as a requirement that "more than half the employee's total earnings **in a representative period** must consist of commissions." The Division of Labor Standards Enforcement has adopted that rule. Because under this rule a representative period is not limited to a single pay period, this suggests that a lack of commission earnings in an individual pay period will not threaten the exemption for that pay period, and that multiple pay periods making up a "representative period" will be used.

Furthermore, requiring that employees receive more than half of their compensation from commissions within every two-week period to qualify for the exemption would arguably eviscerate the exemption. An employee does not "earn" a commission until several steps have been completed after a sale (*e.g.*, shipping, final payment). If more than half of an employee's **earnings** in a pay period must be from commissions, then an employee's initial pay periods could never qualify for the exemption. Even if paid a sizable draw, while an employee's compensation may be sufficiently high, that employee will never be able to earn anything in commissions at the outset of his or her employment.

Accordingly, while the plaintiff's bar will likely look to seize an opportunity to extend *Peabody* to the second prong of the exemption test, it is unlikely that such an effort will prove worthwhile. Unfortunately, the California Supreme Court's express decision to not address the second prong begs the question and the argument that a similar holding should be applied to it.

What Employers Should Do

Employers should immediately review their commission plans to make sure employees will always receive at least 1.5 times the minimum wage for each hour worked up to and including 40. Employers who pay their employees base salaries or hourly rates that already meet the minimum amount have nothing to adjust. Other employers, however, must make sure that their commission plans provide for draws that guarantee compensation for every pay period at 1.5 times the minimum wage.

As for the second prong, employers are not required to take any steps right now. The potential for an extension of *Peabody*, while certainly foreseeable, is neither imminent nor likely. Cautious employers could set a draw for every pay period that is just over the employees' hourly or salaried base compensation. This would be the best method to ensure that more than half of an employee's compensation is derived from commissions.