Drafting Enforceable Sales Commission Plans
Under New York and California Law

By Donna M. Shibata

Employers often encounter problems in drafting enforceable compensation plans for their commissioned sales employees. Contract provisions that might make business sense can run afoul of state wage and hour laws—and to further complicate matters for employers, these laws vary considerably state to state. This Commentary compares New York and California law governing commission plans to illustrate how legal requirements do vary and highlights common, recurring problems encountered in drafting commission plans. Since the employer generally drafts the compensation plan, and therefore any ambiguities will be construed against the employer, it is particularly important that the employer draft the plan carefully and with attention to detail.

The list of problems employers must deal with is similar state to state. Employers often confuse “commissions” with other types of incentive pay such as bonuses and piece rates, which can be subject to different rules. Commission plans often do not comply with state law governing when commissions must be paid during employment and after an employee is discharged or quits. Commission plans often do not comply with state law prohibitions against deductions and “forfeiture” clauses. With care, an employer can avoid these common problems, and minimize the disputes over the timing and the amount of commissions owed and potential exposure to the significant penalties for failure to pay commissions on time.

Commission Payments During Employment

New York

Under New York law, “commission salesmen” must be paid their commissions no later than the last day of the month following the month in which these commissions are earned. For example, if a commission plan provides that a commission is earned in January, the commission must be paid by the end of February. If the commission plan provides that commissions are earned at the end of a quarter, the “commission salesman” rule would require the commissions to be paid by the last day of the month following the end of the quarter. The employee would meanwhile receive his or her salary at least once a month, as it is earned.

“Commission” is defined as “compensation accruing to a sales representative . . ., the rate of which is expressed as a percentage of the dollar amount of wholesale orders or sales.” “Earned commission” means “a commission due for services or merchandise which is due according to the terms of an applicable contract” or, when there are no applicable contractual provisions, “a commission due for merchandise which has actually been delivered to, accepted by, and paid for by the customer, notwithstanding that the sales representative’s services may have terminated.”

Not everyone who earns commissions qualifies as a “commission salesman,” however. Employees whose “principal activity” is selling goods or services are subject to this rule, but not employees whose principal activity is of a supervi-
sory, managerial, executive, or administrative nature. This means that an employee whose primary role is supervising or managing salespeople typically would not qualify as a “commission salesman.” No specific rule governs the timing of commission payments to such employee. An independent contractor working as a “sales representative” also is not a “commission salesman” and is subject to different rules. For example, a sales representative must be paid his or her earned commission in accordance with the agreed terms of their contract, but no later than five business days after the commission has been earned.

California

California’s Division of Labor Standards Enforcement (“DLSE”) takes the position that commissions must be paid on the next regular payday after they have been earned and are “reasonably calculable.” An employer has the flexibility to deem commissions earned either when the sale is made or when the customer pays for the product or service. “Commission” is defined as “compensation paid to any person for services rendered in the sale of such employer’s property or services and based proportionately upon the amount or value thereof.” To be a “commission” under California law, the compensation must arise from the sale of a product, not the making of a product or the rendering of a service or service; and the compensation also must be a percentage of the price of the product or service.

Deductions from Commissions

New York

New York law generally prohibits an employer from deducting any sum from an employee’s commissions and other wages, except for deductions for the benefit of the employee (e.g., pension, health benefits). Examples of prohibited deductions are deductions for spoilage or breakage, cash shortages or losses, and fines or penalties for lateness, misconduct, or quitting by an employee without notice. The reasoning is that the employer should bear the risk of such losses rather than the employee.

California

In California, as a general rule, an employer is prohibited from making deductions from its employee’s commissions and other wages for business losses that are beyond the control of the employee. Employers may not make deductions from commissions for cash shortages, breakages, or losses of equipment that result from simple negligence. An employer is also prohibited from making deductions from commissions to cover the cost of workers’ compensation. Following this line of reasoning, the DLSE issued an opinion letter, dated October 4, 1990, which invalidated an employer’s practice of reducing its employees’ earned commissions for losses incurred through “slow paying accounts” (e.g., bad debts, uncollectible accounts). In this opinion letter, the DLSE found the employer’s practice to be unenforceable because it, in essence, held employees liable for business losses that were beyond their control.

Commission deductions for products that are returned within a certain period of time are generally permissible if it is possible to identify the specific commission at issue and the employee who received that commission. A commission plan that permits deductions for returned products that cannot be attributed to a particular salesperson likely is unenforceable, however.

Commission Payments on Termination

New York

Under New York law, if employment is terminated, the employer must pay the wages, including earned commissions, no later than the regular payday for the pay period during which the termination occurred.

California

California employees who are discharged, or who resign with 72 hours’ notice, are entitled to all wages due at the time of termination. If the resigning employee fails to provide notice, the employer has 72 hours after the resignation to make payment. According to a DLSE opinion letter dated January 9, 1999, if commissions have been “earned” on or before the date of termination, the employer must complete the necessary calculations and pay the commissions at the time of termination. An employer may not wait until the customary time for calculating the commissions of current employees, nor delay payment of earned commissions until the next regularly scheduled pay date. The DLSE recognizes, however, that there are some situations in which commissions are not calculable until after termination and thus are not due until that time.
In California, an employer should evaluate whether a terminated employee should receive pro rata commissions on any of his or her pending sales. Each situation needs to be considered on a case-by-case basis. For example, if an employee is terminated after performing substantially all of the work necessary to earn a commission, an employer may be required to pay at least a pro rata portion of the commission. If the employer discharges an employee and the employee is thereby prevented from completing his or her duties, the employee may be able to recover all or a pro rata share of his or her commissions.

Forfeiture Provisions

New York

In New York, an employee’s right to commissions turns on interpretation of the commission pay plan. Once commissions are earned, they cannot thereafter be forfeited. Commissions, absent an agreement to the contrary, are not generally forfeited by the employee’s discharge or resignation.

California

A California court of appeals has upheld the enforceability of a provision whereby an employee forfeits his or her right to commissions on sales generated during employment where payment for the sales is received after termination of employment. This decision appears to be inconsistent with the predominant view of California courts and the California Labor Commissioner, however. Where an employee had done some work, for example, the Labor Commissioner would be unlikely to enforce a forfeiture provision and instead would deem the commission earned on a pro rata basis.

Penalties for Failure to Properly Pay Commissions

A poorly drafted commission plan can lead to disputes over the timing and amount of commissions owed. In both New York and California, employees can seek to recover unpaid commissions and significant penalties for failure to pay commissions on time.

New York

New York imposes strict penalties for failure to pay commissions and other types of wages. Employees have the right to recover wages (including commissions) earned during the six years preceding the start of the legal action. Aside from recovering the amount of the unpaid wages, an employee can seek an additional penalty equal to 25% of the amount owed and recover his or her attorneys’ fees if the failure to pay was willful. Additionally, such an employer may be required to pay the state labor commissioner a penalty of $500 per violation. Beyond these monetary liabilities, New York law provides that the employer may be considered guilty of a criminal offense. The employer’s first offense would be considered a misdemeanor, and any subsequent offense would be a felony, with each offense punishable by a fine of between $500 and $20,000 and/or imprisonment for up to one year.

California

In California, an employee must file a wage claim with the DLSE or in court within four years if the claim is based on a written agreement. If the employer willfully fails to pay any wages of an employee who is discharged or quits, the employer can be liable for up to 30 days’ wages for the period of the delay, unless the employer can demonstrate that a good faith dispute exists as to whether any commissions were due. The employer also could be subject to a civil penalty for each such missed or untimely payday: $100 for an initial violation, and $200 for each subsequent violation. In addition, for any willful or intentional violation the employer is subject to a penalty of $200 per day plus 25% of the amount unlawfully withheld. The prevailing party also can recover its reasonable attorneys’ fees and costs. In addition, under the Private Attorneys General Act (Cal. Lab. Code § 2699), employees can now bring lawsuits to pursue penalties that in the past were only available to the Labor Commissioner. Beyond these civil penalties, California law provides that any employer who willfully refuses to pay, or falsely denies the amount of, wages is guilty of a misdemeanor.

Tips for Drafting Enforceable Compensation Agreements

As this review of New York and California law illustrates, understanding the applicable state law is essential when
drafting compensation agreements. Care needs to be taken to spell out exactly how and when commissions are earned and paid. Employers can draft clear and enforceable commission plans by keeping in mind the following tips:

- Have a written plan;
- Draft the payment formula to be clear that the payments are “commissions” under the applicable state law;
- Specify when and how a commission is earned, and when the commission will be paid in accordance with applicable state law;
- Specify the deductions, if any, made from commissions in accordance with applicable state law;
- Specify how and when draw arrangements will be reconciled; and
- Specify that all commissions earned on or before the date of termination will be paid when the final base salary payment is made, in accordance with applicable state law.

Because of the stakes involved, especially for national employers, legal review by counsel is a good way to avoid problems based on inadvertent drafting ambiguities.

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1 N.Y. Lab. Law § 191(1-c) provides:

A commission salesman shall be paid the wages, salary, drawing account, commissions and all other monies earned or payable in accordance with the agreed terms of employment, but not less frequently than once in each month and not later than the last day of the month following the month in which they are earned; provided, however, that if monthly or more frequent payment of wages, salary, drawing accounts or commissions are substantial, then additional compensation earned, including but not limited to extra or incentive earnings, bonuses and special payments, may be paid less frequently than once in each month, but in no event later than the time provided in the employment agreement or compensation plan.

2 Cal. Lab Code § 204.1.