Tricky Legal Issues Involving Employee Bonuses and Commissions

By Jonathan Fraser Light

Bonuses and commissions continue to be troublesome topics because employers often enter into these arrangements without thinking about collateral issues.

Discretionary vs. Non-Discretionary Bonuses

An employer sets up a bonus system for employees based on productivity measurements, such as key performance indicators (KPIs"). For hourly workers, this could mean a bonus for a certain number of products created, calls made, deals closed, using safety equipment; pretty much anything. These are "non-discretionary" bonuses. The employer sets the criteria, the employee meets the criteria, and now the employer is obligated to pay the bonus.

A non-discretionary bonus can recur and fluctuate, or it can be fixed. For example, an employer sends repair technicians into the field. Depending on how they perform, they can earn up to seven different categories of bonuses each pay period, each worth $25. The value of the overall bonus for the pay period will fluctuate, depending on how many of the seven metrics the employee meets.

An employer sets up a bonus program that if the company meets 94% of the company's sales target for the year, every employee receives a $500 bonus at the end of the year. This is a "flat rate" non-discretionary bonus. It could also be set up monthly. It all depends on whether the amount would change based on some aspect of performance or production, and then it is considered "fluctuating," but still non-discretionary.

A "discretionary" bonus would be one that the employer often pays, such as a holiday bonus, but is not required to do so, even though it might be expected. Or it could be one in which the employer says, "We had a good quarter and you've been great, here's $500." We typically are not concerned with discretionary bonuses and how they are paid.

Calculating Bonuses into Employee Earnings

It is important to understand the distinctions between the types of bonuses for two critical reasons. First, for a non-discretionary bonus paid to non-salaried people (anyone who is or might be entitled overtime), the bonus must be added to the employee's regular rate of pay for the relevant timeframe in which the bonus was earned. This is then used to adjust upward the value of overtime, sick time, and any meal and rest break premiums owed. If it's a quarterly bonus (or commission), for example, the employer must do a look-back through the entire quarter to "gross up" the overtime and other payments previous made to reflect the value of the bonus or commission.

How the bonus “gross up” is calculated is different depending on whether the non-discretionary bonus is a “fluctuating” bonus or a “flat rate” bonus. That distinction adds to the complexity of the math.

Hidden traps for non-discretionary bonus “gross up” include safety bonuses, recruiting bonuses, longevity bonuses, and cashing out unused sick time (but not vacation or PTO). Note that the state and federal laws differ on the recruiting bonus. California state law illogically requires the employer to add a recruiting bonus to the employee’s overall income for purposes of calculating the gross-up.

Be careful not to subtract from the bonus or commission any “administrative overhead” charges or chargeback fees unrelated to the specific sale that created the bonus or commission. Case law prohibits those types of deductions. The remedy is to reduce in advance the value of the commission to account for those issues, without being specific as to them. It is otherwise illegal to have a blanket, “We reduce your commission by 10 percent to cover administrative overhead or overall customer chargebacks.”

What To Do If an Employee Leaves

Whether paying a bonus or commission, the employer needs to anticipate what happens if the employee leaves before the bonus or commission is entirely earned or paid out. Consider also what happens if a commission must be reversed because the customer returns the product or cancels a service. An employer is entitled to take out the value of overpaid commissions from future commissions but can’t do so retroactively.

If the employee leaves midstream, employers must adequately protect themselves in the commission/bonus document for these “tail commissions” (or bonuses). Tail commissions may be due on customer payments received by the employer on sales for which the employee would otherwise be entitled, but after the employee has departed.

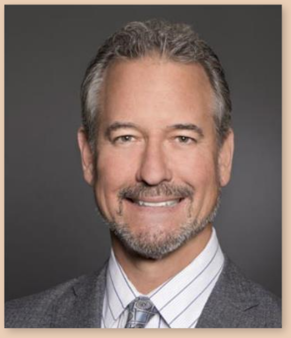
It is important that the employer carefully draft commission language that addresses tail situations. Employers may cut off payment but should do so only after a reasonable period after termination. The law doesn’t like forfeitures, especially when the employee has “earned” the commission on the sale, but payment hasn’t come in yet because of the lag time it usually takes.

This is especially problematic when the employer terminates the employee and effectively prevents the employee from earning the commission because of the termination. The law favors the employee in these situations, which is typically even more reason for employers to be careful about how they draft bonuses and commission documents.

Note that with California employees, all commission agreements must be signed by both parties. Employers should track the issuance of and signature on a new commission plan. If an employee doesn’t sign, there is an argument that the employee is entitled to be paid under an earlier signed plan. There is a counterargument that if employees continue to work under the unsigned plan, then they may be prohibited from rejecting that plan and trying to collect under an earlier, more generous plan. For employers, it is best not to test that theory in court. Tighten up the documents.

Commissions or bonuses for inside salespeople are especially problematic. For these employees, have their payment plans reviewed for legal compliance. You may owe overtime on those payments (and on regular pay) and not realize it, even if they are paid on salary.

Employees sometimes try to characterize bonuses as discretionary when they are clearly non-discretionary. That's going to backfire in most instances, so employers should be careful about how they label the bonus to ensure that they stay in compliance. These types of missteps are one of the key areas in which employers are most likely to be sued in class action and PAGA cases. Don't blame California for this one, as federal law generally follows the same rules.



Jonathan Fraser Light is the Managing Attorney at LightGabler, which serves almost 3,000 small and large public and private sector employers (for-profit and non-profit) in a variety of industries. Jonathan specializes exclusively in representing employers in employment litigation and day-to-day advice and counsel. Contact Jon at jlight@lightgablerlaw.com.