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Commissioned Salespeople & The Fair Labor Standards Act: Non-Compliance is a Costly Matter

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Many employers erroneously believe that there is a general exemption from the minimum wage and overtime requirements for so-called "commission" sales employees. While this is true under Maryland law — the state minimum wage and overtime requirements do not apply to individuals who are compensated on a commission basis — no such broad exemption exists under the Fair Labor Standards Act. The FLSA does provide certain limited exemptions from both minimum wage and overtime for "outside salesmen"; the FLSA also provides a limited exemption from overtime (but not minimum wage) for commission employees of "retail and service establishments." Qualifying for either of these exemptions, however, is much more difficult than employers realize. Moreover, even assuming that an employee's job responsibilities make him or her eligible for the exemption, the wage payment structure that can be required by the FLSA for these employees is quite complex and often misapplied by employers. As a result (and perhaps because liquidated damages and attorneys' fees are recoverable by an employee in a successful wage payment action), there has been a recent flood of claims on behalf of employees who were compensated on a commission basis and who assert, often correctly, that they were underpaid. Therefore, it is critical that counsel for employers and employees understand exactly what is required.

Wage & Hour Basics

Any analysis of how a salesperson should be compensated must start with the FLSA basics. Unless an employee is specifically exempted from federal and state wage and hour regulations, he or she must be paid at least minimum wage, which is $5.85/hr, under federal law and $6.15/hr. in Maryland. In addition, an employee also must be paid overtime pay for hours worked in excess of40 in a workweek at a rate not less than time and one-half his or her "regular rate of pay." Compliance with these provisions can be very costly for employees who receive sizable commissions since an employee's "regular rate of pay" under the FLSA is computed by dividing the total remuneration paid to the employee in the workweek by the total number of hours of work in the workweek for which such compensation was paid. That total remuneration includes commissions. Thus, if an employee's total remuneration in a week was a S10,000 commission which was earned during a 45-hour workweek, the employee's "regular rate of pay" for purposes of overtime would be $222.23/hour. If the employee is not exempt from overtime, the employer would be required by the FLSA to supplement the S10,000 commission by paying an additional $1.667 for the 5 hours of overtime worked. An exemption from overtime pay thus is critical for employees who earn substantial commissions because their "regular rate of pay" is determined by including commissions.

The Outside Sales Employee Exemptions

Section 13(a)(1) of the FLA provides an exemption from both minimum wage and overtime pay for employees employed as *bonafide* executive, administrative, professional and outside sales employees. Many employers assume—incorrectly it turns out—that sales staff who visit customers in the field to make sales automatically qualify for the FLSA's "outside sales" exemption even if the employees spend much of their time in the office or in their homes, making telephone calls and generating leads.

A recent case from the United States District Court for the District of Maryland, *Schultz v. All-Funds, Inc.. 2007 U.S. Dist. LEXIS 59300 (D. Md .Aug 13, 2007)*, has an excellent discussion of the applicable law and demonstrates the requirements and perils associated with the outside sales exemption. That case involved claims by the former co-branch managers of All Fund. Inc. and Amerifund Financial. Inc. who were paid on a straight commission basis for loans they originated. The defendants were two financial services companies, an industry that frequently pays its sales staff on a straight commission basis and which has been the recent subject of many wage claims by aggrieved sales employees.

As is the practice with many financial services companies, if the plaintiffs did not close a loan, they did not receive any compensation for work they performed. Consequently, there were pay periods during the loan officers' employment in which they did not receive any compensation at all even though they had worked during those pay periods to generate business that might pay a commission at a later date. In addition. neither the defendants nor the plaintiffs kept any concurrent record of the hours that the plaintiffs worked, presumably because the employees were being paid on a commission basis (instead of hourly), and the employer therefore believed the records were unnecessary.

In response to the lawsuit, the defendants argued that the former employees were exempt from both minimum wage and overtime pursuant to the outside sales exemption in Section 13(a)(1) of the FLSA. Under the statute. in order to qualify for the outside sales exemption. the following criteria must he satisfied:

> I) the employee's primary duty must be making sales, or obtaining orders or contracts for services or for the use of facilities for which a consideration will be paid by the client or customer; and
>
> 2) the employee must be customarily and regularly engaged away from the employer's place or places of business.

The first prong of this two-part test is easy to satisfy since it basically only requires that the employee be engaged in sales. The second prong of this test. however, is much more difficult to satisfy than employers often realize. The applicable regulations, which define what it means to be "customarily and regularly engaged in sales away from the employer's place of business." state:

> The outside sales employee makes sales at the customer's place of business, or, if selling door-to-door, at the customer's home.

C.F.R. § 541-502.

Perhaps even more important than how the regulations define outside sales is what the regulation says will not constitute outside sales:

> Outside sales does not include sales made by mail, telephone or the Internet unless such contact is used merely as an adjunct to personal calls. Thus, any fixed site, whether home or office; used by a salesperson as a headquarters or for telephonic solicitation of sales is considered one of the employer's places of business, even though the employer is not in any formal sense the owner or tenant of the property.

Applying these legal principles, the Schulz Court granted the employees' motion for summary judgment and awarded more than $100,000 to the two former mortgage loan officers for their employers' failure to pay minimum wage and overtime.

The parties appeared to agree that plaintiffs' primary duties involved making sales and therefore satisfied the first prong of the two-part test. The dispute centered on whether the employees' job responsibilities satisfied the second prong, i.e., whether they were regularly and customarily engaged in sales "away from the employer's place of business." The plaintiffs argued that they worked primarily from the branch office and were not regularly engaged in making sales outside of defendants' place of business. In support of their contention, the plaintiffs submitted detailed affidavits stating that they spent the overwhelming majority of their time originating loans from within the branch office and, for example, spent over ninety percent of their total work the communicating with clients and potential clients by phone, e-mail, and in writing from within the office.

The Court found that defendants' affidavit, which contained a general assertion that the plaintiffs were sometimes away from the office making sales calls and following up on leads, was insufficient evidence as a matter of law. Indeed. the Court stressed that where an employer asserts an exemption from the requirements of the FLSA as an affirmative defense, it also bears the burden of proof to show that the defense is applicable. Thus, in order to establish the exemption, the defendants were required to prove that the loan officers were "customarily and regularly" engaged in outside sales work, regularly meeting with clients and conducting business outside of the branch office. Having failed to do so, the Court held that the loan officers were therefore not exempt under the FLSA.

Having lost on the merits, the employers were then further devastated by the fact that they had no records of the hours worked by the former employees. In opposition to the employees' summary judgement motion, the employers argued that at least there was a genuine issue of material fact on the question of whether plaintiffs performed work for which they were not properly compensated. The Court found, however, that plaintiffs' affidavits provided evidence from which the Court could reasonably infer that the former employees worked 35 to 54 hours a week. If an employer fails to keep records of employees' hours under the FLSA, the employer is at fault, and an employee is not required to provide a precise accounting of the hours worked to prove a violation of the FLSA.

In addition, the Court awarded liquidated damages to plaintiffs, as is customary in cases in which the FLSA is violated. Indeed, the Court noted that in such cases the employer bears a substantial burden of persuading the court by proof that its failure to obey the statute was both in good faith (which implies some duty to investigate potential liability under the FLSA) and that the failure was predicated upon reasonable grounds. In *Schultz*, the defendants attempted to meet this burden by relying upon an opinion letter from the United States Department of Labor ("DOL"), addressed to the President of the National Association of Mortgage Brokers. That Opinion Letter had concluded that certain mortgage loan officers described by the President of the Association would qualify as exempt under the outside sales exemption. The *Schultz* Court, however, was not persuaded because the

Opinion Letter was predicated on a factual proffer by the President of NAMB that the mortgage brokers at issue "perform[ed] their work primarily outside the office." Since the Court found that the *Schultz* employees had not primarily worked outside the office, and since the employers had made no attempt to investigate and/or determine the extent to which these particular plaintiffs worked inside or outside the office before classifying them as exempt, the Opinion Lelter did not demonstrate that the employers had acted reasonably and in good faith, such as would justify denying an award of liquidated damages to the former employees.

As the *Schultz* opinion makes clear, the outside sales person exemption applies only where employees are spending most of their time in outside sales, meeting face to face with potential customers to solicit and sell products and/or services. Thus, employers (and their counsel) must closely evaluate the nature of the business and the duties actually performed by sales staff before classifying any sales employee as exempt under the outside sales exemption. Moreover, despite the inherent difficulty in tracking the hours of employees who make sales calls or who may work from home, the result in *Schulz* highlights the importance of maintaining accurate records of hours worked, as they can be especially important to limit a potential award of damages for unpaid wages.

The Exemption For Retail and Service Establishments

Federal FLSA regulations also create a second exemption from overtime for commission-paid salespersons under a special exemption for sales employees of "retail or service establishments." This is an exemption only from overtime; it is not an exemption from minimum wage. To the contrary, as outlined below, in order to utilize this exemption, sales employees must be paid an hourly rate of pay that is *greater* than the applicable minimum wage, a classification that can nonetheless be important to employers because the employees who fit within this exemption need not be paid overtime for hours worked over 40 in a given workweek.

In addition, the nature of the analysis that is required under this exemption means that employers must evaluate each employee to determine whether he or she is eligible for the exemption; depending on each employee's relative success in generating commissions, one salesperson might be exempt from overtime under the retail and service establishment while another salesperson, doing exactly the same job for the same employer, is not.

A sales employee will qualify under the exemption only if (1) the employee works in a retail or service establishment and (2) the employee receives a regular rate of pay that is in excess of one and one-half times the applicable minimum wage: and (3) more than half of the employee's compensation represents commissions on goods or services. The first prong of this three-part test is straightforward. "Retail and service establishments'' are defined as establishments that are recognized in the industry as retail or service businesses engaged in the business of making the sales of goods or services, and whose annual dollar volume of sales of foods or services (or of both) includes no more than 25% of sales made for resale purposes. 29 C.F.R. $ 779.313; 29 C.F.R. $779.21. The remaining two prongs of this test can create an accounting nightmare for employers, both in terms of determining whether a particular employee fits within the exemption and in terms of ensuring that an employee is paid properly as his or her commissions and hours of work fluctuate.

To determine whether a sales employee is being paid "more than one and one-half times the applicable minimum wage," the employer may determine the employee's total earnings (whether in commissions, base salary, advances, or some combination) that are attributable to a given pay period and then divide that total compensation by the employee's total hours worked during the pay period.[1] If the result is greater than 1.5 times the minimum wage for every hour worked (including any hours over 40), this portion of the exemption has been met. Given the fluctuations in the amounts earned by commissioned salespeople, however, it can be difficult to ensure that this will be satisfied each and every pay period. For this reason, and to help salespeople deal with wild fluctuations in income, employers may institute a compensation program that includes regular advances of commissions to guarantee a basic level of income. Under this kind of program, and to ensure that commissioned sales employees are properly paid for each hour worked, employers may advance commission payments, subject to a requirement that the employees ultimately repay the money that was advanced over a specified period of time as commissions are earned. (This reference to repayment of the advances from commissions does not suggest that an employer may recover the amounts paid if earned commissions are insufficient to cover the advance.) This practice, which typically involves advances, reconciliations. carrying forward of deficits and credits, etc. must be performed in accordance with specific, and very complex, wage regulations that are too complicated and fact specific to explain detail here. The applicable regulations also require that an employer must obtain written employee authorization from each employee with regard to wage reconciliations and deductions.

Finally, to qualify for the retail and service establishment exemption for salespeople, the employer must determine whether more than 50% of an employee's wages are commissions for sale of goods or services. If the employee is paid entirely by commissions, or through a combination of draws and commissions, or if commissions are always greater than salary or hourly amounts paid, the-greater-than-50%-

commissions condition will have been met. If the employee is not paid in this manner (for example, if the employee gets paid a base salary, plus commissions), the employer must select a "representative period" and then determine the employee's commissions and other compensation paid during a representative period. The regulations provide employers with limited discretion in determining the "representative period" for evaluating whether a sufficient proportion of wages were earned as commissions; according to the regulations, the period may be as short as one month, but must not be greater than one year. The employer then must calculate whether more than 50% of a particular employee's compensation was paid as commissions. If so. he or she may be deemed exempt from overtime under the retail or service establishment exemption.

Advising Employers and Employees

The improper classification of employees under the wage and hour laws can be quite costly for all involved. Yet, employers often misunderstand and misapply these laws to their sales employees who are paid commissions. Careful attention to the applicable regulations, and cases interpreting such laws, is a must. The importance of regular wage and hour audits for employers in sales related industries also cannot be underestimated. All too often, these employers fail to pay their employees in accordance with the law and it is only a matter of time until they are faced with a complaint, or multiple complaints, for unpaid wages, liquidated damages, as well as attorneys' fees and costs. Wise counsel from their attorneys is necessary to help them understand and apply the law so as to avoid litigation with their employees and attention from the Department of Labor.

Notes

[1] It also can be complicated to determine precisely when a commission that is paid for work performed over an extended time period is "earned for purposes of the FLSA.

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