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Client Alert

A report for clients and friends of the Firm

June 2008

New York's High Court Upholds Commission Agreements Subject to Adjustments and also Finds Executives Are Not Exempted from the Wage Deduction Prohibition

On June 10, 2008, the New York Court of Appeals ruled in *Pachter v. Bernard Hodes Group, Inc.* that executives are included in the definition of "employee" under Article 6 of the New York Labor Law, and, as such, Labor Law § 193, the state wage law that prohibits employers from deducting the wages of employees, applies not only to rank-and-file workers but to executives as well. Significantly, however, the Court also ruled that where an executive subject to a commission arrangement agrees (either expressly or impliedly through a course of conduct) that commissions are *not* earned (and, hence, do not constitute "wages") until related expense deductions are made, such an arrangement is lawful under the Labor Law and will not contravene § 193. Accordingly, New York's highest court has upheld computation arrangements that clearly subject commissions to adjustments from gross sales, billings or receivables, and/or to deductions for business-related expenses *before* a commission is "earned" or vested. In light of this decision, employers are advised to review the compensation structures in place for all executives to ensure that they comply with this new interpretation of New York's Payment of Wages law.

Background

From 1992 to 2003, Elaine Pachter was a vice-president for Bernard Hodes Group, Inc. ("Hodes"), a recruitment, marketing, and staffing services company. She was responsible for preparing, placing, and servicing advertisements for Hodes' clients, and she was paid on a commission basis for her work.

When a client of Hodes agreed to a media buy, Hodes would advance payment to the media company and the client would later reimburse Hodes and pay a fee for Pachter's services. When the client was billed, Pachter received a percentage of the amount billed minus charges for such things as losses attributable to errors in placing advertisements, uncollectible debts, travel and entertainment expenses, as well as for half her assistant's salary. Each month, Pachter received a commission statement that listed her total billings and the percentage of those billings that represented her gross commission. Included also was an itemized listing of business expenses, losses and charges made against her "total income," and any advances she had drawn from her commission account. These adjustments and charges were then deducted to reach the net amount of commission income she had earned for that period. Pachter never agreed in writing to these adjustments and deductions but was aware that Hodes subtracted them from her gross commissions and she acquiesced in this compensation scheme for 11 years.

Pachter Sues Hodes for Expense Deductions

After leaving Hodes in 2003, Pachter filed a lawsuit in the U.S. District Court for the Southern District of New York (she and Hodes were in different states). She claimed that the deductions taken from her commissions were improper under New York Labor Law § 193, which prohibits an employer from making any deduction from the wages of an employee (including earned commission payments) unless permitted by law or authorized by the employee for "insurance premiums, pension or health and welfare benefits, contributions to charitable organizations, payments for United States bonds, payments for dues or assessments to a labor organization, and similar payments for the benefit of the employee." Pachter argued that Hodes unlawfully made adjustments to her gross commissions. The New York federal and state courts were split on the issue as to when commissions are earned as well as whether executives were subject to the prohibitions on wage deductions.

Hodes argued that, as an executive, Pachter was exempt from Labor Law § 193, and, in any case, the deductions were not taken from "earned" commissions, but rather were subtracted during the process of determining what Pachter's "earned" commission payment would be.

The federal district court granted summary judgment in Pachter's favor, and Hodes appealed to the U.S. Court of Appeals for the Second Circuit, which certified to the New York Court of Appeals two questions: 1) Does the wage deduction statute apply to executives, and 2) Were Pachter's commissions "earned" before the deductions were taken.

The Court of Appeals Decision

Article 6 of New York's Labor Law statute governs the payment of wages by employers. While § 190(2) defines an "employee" as "any person employed for hire by an employer," certain subdivisions in § 190 explicitly exclude executives.

Writing for the New York Court of Appeals, Judge Graffeo found that while executives are explicitly removed from the definitions of certain subcategories of employees in Labor Law § 190 (such as the definitions of "railroad worker" and "commission salesman" under § 190(5) and §190(6), respectively), those provisions do not affect the inclusion of executives in the definition of "employee" under § 190(2). As the Court explained: "[T]here would be no need to eliminate executives from the enumerated subcategories of employees if they were not within the ambit of the general definition of 'employee' in subdivision (2)." As such, the Court held, "executives are employees for purposes of Labor Law Article 6, except where expressly excluded."

Turning to the second question, it was undisputed that the charges Hodes made to determine Pachter's final compensation were not within the categories of permissible deductions delineated in § 193. Therefore, their legality depended on when Pachter's commissions were "earned" and became a vested wage that was subject to the restrictions of § 193. If the adjustments were made before the commissions were earned, § 193 did not prohibit them; but if the charges were subtracted *after* her commissions were earned, Hodes engaged in impermissible practices under the statute.

The common-law rule in New York is that a commission is "earned" when a broker produces a buyer ready and willing to enter into a contract on an employer's terms. Still, New York courts have recognized that parties are free to set their own conditions for the earning of commissions, and can provide that the computation of a commission will include certain downward adjustments from gross sales, billings or receivables, including deductions for expenses. If an employer and employee enter such an agreement, the Court explained, "the commission will not be deemed 'earned' or vested until computation of the agreed-upon formula." Thus, "when a commission is 'earned' and becomes a 'wage' for purposes of Labor Law Article 6 is regulated by the parties' express or implied agreement; or, if no agreement exists, by the default common-law rule that ties the earning of a commission to the employee's production of a ready, willing and able purchaser of the services."

In Pachter's situation, the Court wrote, the "lack of a specific written contract is not determinative" because the 11-year employment relationship and Pachter's acceptance of monthly statements that showed deductions/adjustments provided "ample support" for a conclusion that she and Hodes had an implied contract under which the "final computation of the commissions earned" by Pachter was not performed, nor vested, until work-related adjustments (*e.g.*, non-payment of customers and the cost of Pachter's assistant) and business-related expenses were subtracted.

What This Decision Means for You

In light of the New York Court of Appeals' ruling that executives are included in the definition of "employee" under the New York Labor Law, employers are advised to review their policies to ensure that executives' wages (including commissions) are not reduced for reasons other than those explicitly approved in the Labor Law. Next, where executives earn incentive compensation or commissions subject to deductions and adjustments, employers are well advised to have in place express written agreements explaining that commission or incentive compensation wages are *not* earned until *after* enumerated deductions/adjustments are subtracted. While Hodes prevailed here because of a long-standing practice that was evidence of a clear course of conduct, employers would be wise to get it in writing.

More broadly, employers should beware that, except where explicitly excluded, executives are now considered "employees" for all purposes under Article 6 of the Labor Law. This means, for example, that Article 6's prohibitions on gratuity-sharing and kickbacks apply to executives as well as rank-and-file employees, and, like all other employees, such executives are permitted to file complaints with the Labor Commissioner regarding such violations.

Notably, just this past October 2007, New York amended § 191(c) of the Labor Law to provide that in the absence of a written agreement concerning commission salespersons, the law will presume that the terms of employment presented by the employee "are the agreed terms of employment." (See Proskauer's October 2007 Client Alert on the NYLL amendments.) While executives are expressly excluded from the definition of a "commission salesman," the *Pachter* decision signals that whether included (*e.g.*, commissioned salesman) or excluded from coverage (*e.g.*, supervisors, managers, and executives), New York's highest court has weighed in on the importance of having an agreed-upon commission formula, whether that be in writing or implied from an accepted course of conduct. Thus, one important take-away from *Pachter* for employers that extends to those working on a commission basis in sales, financial services, insurance and mortgage loan industries is that the commission arrangement can be structured so that the commission is *not* deemed earned until *after* gross commissions have been adjusted to account for advances, trade errors, losses occasioned by non-payment, finance charges associated with clients who do not pay promptly, marketing and other business-related expenses. Employers are best served, moreover, if this arrangement is set forth in a signed writing.

If you have any questions regarding this Client Alert, please contact your Proskauer relationship lawyer or any of the lawyers listed below.

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