

## **California Supreme Court Approves Compensation Practice of Using Clearly Delineated Lump-Sum Payments for Reimbursing Employee Expenses**

**November 16, 2007**

On November 5, 2007, the California Supreme Court issued its opinion in *Gattuso v. Harte-Hanks Shoppers, Inc.*, holding that an employer may indemnify employees for reasonable and necessary business expenses under California Labor Code § 2802 (Section 2802) by paying employees enhanced compensation in the form of salary or commissions. The Court concluded, however, that there must be a means or method for apportioning the enhanced compensation between expense reimbursement and wages/salary, so as to delineate which amount is for labor performed and which is to meet its reimbursement obligation.

### **Background: Facts and Claims**

The plaintiffs in *Gattuso* were outside sales representatives responsible for selling advertising space in the defendant's publications. They drove their own automobiles to meet customers in person at their places of business. The defendant also employed inside sales representatives who contacted customers by telephone from the defendant's offices. The outside sales representatives were not separately reimbursed for their automobile expenses. Instead, they were paid higher base salaries and/or commission rates than the inside sales representatives. The plaintiffs brought a class action seeking indemnification under Section 2802 for their automobile expenses. In the trial court, the defendant argued that this higher compensation satisfied its obligation under Section 2802 to indemnify its employees "for all necessary expenditures or losses incurred by the employee in direct consequences of the discharge of his or her duties, or of his or her obedience to the directions of the employer. . . ." The requirements of Section 2802 apply to all California employees, regardless of whether they are exempt or nonexempt from other state and/or federal wage and hour laws.

The trial court agreed with the defendant and further concluded that a reasonable rate of reimbursement could be determined by the employer or by agreement between the employer and employee. The trial court also denied the plaintiffs' motion for class certification. The Court of Appeal affirmed the trial court's rulings.

### **The Supreme Court's Reasoning**

The Supreme Court first confirmed that Section 2802 requires employers to fully reimburse their employees for expenses actually and necessarily incurred in performing their employment tasks. Whether an expense is necessary will depend on what is reasonable under the circumstances.

The Court then confirmed that both the “actual expense” reimbursement method and the “mileage reimbursement” method satisfy an employer’s obligations under Section 2802. Under the actual expense method, an employee records and submits actual automobile expenses for employer review and payment if reasonable and necessary. The Court observed that few employers use this burdensome method. Under the alternative mileage reimbursement method, an employee tracks the number of miles driven for work purposes, which is then multiplied by a predetermined amount (such as the IRS reimbursement rate). The Court held that while an employer and employee may agree upon a mileage reimbursement rate, such an agreement does not relieve an employer of its obligations to provide complete reimbursement for all actual expenses that are reasonable and necessary. Therefore, an employee must be permitted to challenge the resulting reimbursement method.

The main issue in *Gattuso* was whether an employer could use a third method of reimbursement—“the lump sum method”— which provides employees with a “non-correlated” increase in salary or commissions to cover expenses. The Court explained that Section 2802 does not preclude the payment of a lump sum amount, *provided* it is sufficient to fully reimburse employees for actual expenses necessarily incurred. The Court made clear that an agreed upon lump sum payment does not relieve an employer from its obligation to pay full reimbursement, or bar an employee from challenging the payment as insufficient to cover his or her expenses. Further, an employer must ensure that some method or formula exists to separately identify (1) the amount intended for labor performed and (2) the amount for expense reimbursement. Employees can then measure their actual expenses against the latter amount.

The Court rejected the plaintiffs’ argument that a lump-sum method would violate Section 226 of the Labor Code because it does not provide required wage statement information. Instead, the Court stated that employers “in the future” should separately identify on wage statements the amounts representing payments for labor performed and the amounts representing business expense reimbursement.

The Supreme Court remanded the case to the trial court with instructions to consider the following questions: (1) Did the company have a practice or policy of reimbursing outside sales representatives through increased commissions or salary? (2) If so, was there a method to apportion between payments for labor performed and expense reimbursement? and (3) If so, was the amount apportioned for expenses enough to fully reimburse the employees for reasonably and necessarily incurred expenses? Upon review of the trial court’s rejection of class certification, the Supreme Court directed the trial court to reconsider the appropriateness of a class action.

### **Implications of *Gattuso* for Expense Reimbursement Policies**

The Supreme Court’s approval of the lump-sum method for reimbursing employees for business expenses gives employers greater flexibility in meeting their obligations under Labor Code Section 2802. Caution: An employer must still ensure that all necessarily incurred expenses are reimbursed, and must use a compensation method that separates the wage and expense reimbursement payments so that employees can determine whether all actual expenses have been fully reimbursed. On balance, some employers may decide that the mileage reimbursement method is preferable.

The decision also highlights other expense-policy issues that employers should review, including: (1) what travel/automobile expenses should be included as reimbursable expenses; (2) what insurance requirements, to cover accidents or other losses, can/should be placed on employees driving vehicles for company business and whether any insurance costs must be reimbursed; and (3) what other expenses

incurred by employees in California (and elsewhere) are subject to reimbursement under applicable law.

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