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California Supreme Court holds that employers may reimburse employees for business-related expenses by paying increased commissions or base salaries; so long as employers apportion between compensation for work performed and reimbursement for business-related expenses.

## California Edition

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### California Supreme Court Endorses “Lump Sum,” Increased Compensation Method for Employee Reimbursements

By Tyler M. Paetkau and Hilary J. Vrem

In *Gattuso v. Harte-Hanks Shoppers, Inc.*, Case No. S139555 (Nov. 5, 2007), the Supreme Court of California held that employers may reimburse employees for business-related expenses pursuant to Labor Code section 2802 by paying them increased compensation, but cautioned that employers must apportion between compensation for work performed and reimbursement for business-related expenses.

#### Facts and Background

The employer in *Gattuso*, Harte-Hanks Shoppers, Inc., is a California corporation that prepares and distributes advertising booklets, including the PennySaver, and employs both inside and outside sales representatives. Outside sales representatives travel to customer locations using their own personal vehicles, and inside sales representatives primarily work at designated employer-owned locations utilizing employer-owned equipment. Harte-Hanks compensates both inside and outside sales representatives with commissions on advertising sales or a combination of base salary and commissions. With respect to the outside sales representatives, Harte-Hanks reimburses the employees for business-related travel expenses by paying increased commissions or higher base salary than the inside sales representative. The plaintiffs, a current outside sales representative and a former outside sales representative, on behalf of themselves and other Harte-Hanks outside sales representatives, brought a putative class action seeking indemnification under California Labor Code section 2802 (“Section 2802”) for expenses incurred while using their personal vehicles for work. Section 2802, subdivision (a) provides: “An employer

shall indemnify his or her employee for all necessary expenditures or losses incurred by the employee in direct consequence of the discharge of his or her [employment] duties ....” Subdivision (c) of Section 2802 defines “necessary expenditures or losses” to include “all reasonable costs.” Harte-Hanks argued that payment of increased compensation to the outside sales representatives complied with Section 2802. The plaintiffs argued that Section 2802 requires employers to use a “correlated” business expense reimbursement method, - i.e., employers must reimburse employees for their actual business expenses on a dollar-for-dollar basis.

#### California Supreme Court’s Analysis

The Supreme Court identified several valid methods an employer may use to reimburse its employees for business expenses. The “actual expense” method requires employees to keep detailed records of all expenses incurred and submit records to the employer for reimbursement. Although this method is likely the most accurate way to reimburse employees, it also is the most time-consuming and administratively burdensome for both employers and employees, as employees must keep detailed records of all costs associated with operating an automobile, including mileage, fuel, insurance, repairs, maintenance, registration and depreciation. Employees must also keep track of what expenses were incurred as a direct result of the performance of their jobs. Once employees submit this information and records to the employer, the employer must then determine which incurred expenses were necessary to the employees’ performance of their jobs.

Another reimbursement method that the Supreme Court discusses is the “mileage reimbursement” method. Under this method, employees must only keep track of mileage for business travel, and the employer then multiplies the number of miles driven by the Internal Revenue Service (IRS) mileage rate, which takes into account such factors as fuel, maintenance, repairs and depreciation. The IRS mileage rate is widely accepted and used for this method. This mileage reimbursement method is inherently less accurate than the actual expense method, as approximations as opposed to actual incurred expenses are used to determine the amount of reimbursement.

The third expense reimbursement method discussed by the Supreme Court is the “lump sum” method. This method does not require employees to keep any records or submit any information to the employer. Instead, the employer pays an employee a fixed amount as reimbursement of business expenses. The fixed amount is derived from the employer’s general understanding of the expenses incurred by employees, including the average number of miles driven or automobile-related expenses incurred. In *Gattuso*, *Harte-Hanks* utilized the lump sum method, which the plaintiffs claimed violated Section 2802. The Supreme Court agreed with *Harte-Hanks* that Section 2802 did not require a “correlated” reimbursement method, and that Section 2802 does not proscribe or restrict the method of employee reimbursement, so long as the method used provides employees with full reimbursement for all actual expenses necessarily incurred in the discharge of their employment duties.

The Supreme Court noted that although employers and employees can enter into an agreement or negotiate the terms or method of employee reimbursements, the agreement could become null and void if an employee challenges the amount of the reimbursement and can demonstrate that he or she has not been fully and adequately reimbursed as Section 2802 requires. The Supreme Court also cautioned that employers must take into account potential tax consequences associated with different methods of employee reimbursement to ensure compliance with Section 2802.

As the Supreme Court concluded that any reasonable method of calculating employ-

ee expense reimbursements was permissible under Section 2802, provided that employers adequately reimburse employees, the court turned to whether an employer could combine employee expense reimbursements with payment of an employee’s regular compensation. The plaintiffs argued that *Harte-Hanks* must pay employee expense reimbursements separately from the employees’ regular compensation for several reasons, including that the statutory definition of “wages” under Labor Code section 200 excludes business expense reimbursement payments. The Supreme Court disagreed with the plaintiffs’ interpretation, opining that an amount payable as wages may be fixed by a contract for employment that may specifically contemplate business-expense reimbursements. As such, an employer may provide for employee-expense reimbursements through an enhanced compensation plan or payment including an increase in base salary or commissions or a combination of both. However, an employer must provide a method or formula to identify the amount of the combined employee compensation payment that is intended to provide expense reimbursement.

## Compliance Suggestions

- The Supreme Court opined that Section 2802 does not restrict the method an employer may use to reimburse employees for business expenses, so long as whatever method an employer uses fully reimburses employees in compliance with Section 2802. Thus, if employers use the “lump sum” reimbursement method, they should provide a mechanism for employees to challenge any alleged under-payments.
- An employer that chooses to link expense reimbursements through an increase in compensation (e.g., commission or base salary) runs the risk that an employee may earn less commission than the employer had anticipated, resulting in a failure to fully reimburse the employee for his or her business-related expenses. If this occurs, it is again the employer’s responsibility pursuant to Section 2802 to provide the employee with the difference.
- Further, the “lump sum” method requires employers to apportion the amounts

intended to reimburse the employee for the business-related expenses, as distinct from the compensation for work performed. To comply with California Labor Code section 226(a), which requires employers to provide an “accurate itemized statement in writing” with each paycheck of various payroll information, including gross wages, total hours worked, all deductions, and net wages earned, employers that provide business expense reimbursements through increases in salary or commission rates should separately identify the amounts that represent payment for labor performed and the amounts that represent reimbursement for business expenses.

Employers also should note that the California Division of Labor Standards Enforcement (DLSE), on its website has a proposed regulation regarding travel expense reimbursement under Section 2802, at <http://www.dir.ca.gov/dlse/2802Regs.htm>. The link is to the DLSE’s Notice of Proposed Rulemaking, Title 8 of the California Code of Regulations, Sections 13700 through 13706.

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