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Bonus Plans May Have Unintended Consequences

by J. Kevin Lilly

California employment law is filled with examples of the law of unintended consequences. One recent example of this principle is how the state's courts have applied wage and hour law to bonus plans. Such plans have been a popular means of sharing profit and attracting and retaining quality employees. However, recently courts have applied statutes designed to protect employee wages in a way that may make it difficult or even impossible to maintain bonus plans, at least for nonexempt employees.

Most profit sharing plans encourage workplace goals like increased sales, control of costs, or even workplace safety and litigation avoidance. Employees whose business units are successful earn increased bonus compensation for achieving these goals as set by management.

Other plans are more generic, simply sharing portions of the net profit of the enterprise. Until recently, courts generally have regarded an employer as "free to … use any formula that it desired" to calculate a bonus. *Division of Labor Law Enforcement v. Safeway Stores*, 96 Cal. App. 2d 481 (1950).

Although few were aware of it, employee bonus plans have been on a collision course with state's Wage and Hour law. The California Labor Code has long protected employee wages by prohibiting an employer from collecting rebates from employee wages, or requiring employees to post bonds except under certain circumstances. Section 3751 prevents employers from recouping the cost of worker's compensation premiums from employee wages.

Courts have increasingly expanded the scope of these protections to the point where even common profit sharing agreements may be challenged in class action.

This expansion occurred over time. California wage orders have prohibited making deductions from wages for any cash shortage, breakage, or loss of equipment unless the employer can show that the loss was caused by a dishonest, willful, or culpable act by the employee.

The state Supreme Court applied that order to prohibit an employer from deducting shortages or breakage from sales commissions. *Kerr's Catering Service v. Department of Industrial Relations*, 57 Cal. App. 2d 319 (1962). Seventeen years later, this prohibition was applied in *Qullian v. Lion Oil Company*, 96 Cal. App. 3d 156 (1979). In that controversial case, a court held that a convenience store manager's "bonus" plan, in which store shrinkage was deducted from sales to determine a bonus, was really an unlawful wage deduction.

More recently, the court in *Hudgins v. Neiman Marcus Group, Inc.*, 34 Cal. App. 4th (1995), held that returns on sales not attributed to the employee could not be deducted from the employee's commissions.

With the advent of the California employment class action firestorm, plaintiffs' lawyers have taken the next step. In at least six class actions, plaintiffs purporting to represent employees have filed class actions challenging a wide variety of bonus plans whenever a bonus deducts costs when calculating the bonus.

Trial courts, sometimes reluctantly, have held that case law, and particularly *Quillian*, required them to find these plans in violation of the law.

Things came to a head when Judge Mary Ann Murphy denied a demurrer to the complaint in *Ralphs*

Grocery Company v. Superior Court (Swanson). In doing so, she certified the case for interlocutory review, and the Court of Appeal accepted the writ. The case was hotly contested and widely watched by the employment bar.

Murphy's decision, issued on Oct. 23, 2003, didn't really make anyone happy. Even the Court appeared to regret the need to regulate a popular means of employee compensation: "*Ralphs* ... present[s] persuasive arguments ... that profit-based compensation plans benefit both employers and employees. Notwithstanding ... *Quillian* ... *Ralphs* also forcefully demonstrates that, as a matter of economics, calculation of an incentive bonus based on profitability by taking into account not only revenues but also store expenses in accordance with standard accounting principles differs markedly from reducing ... wages through prohibited deductions.

Nonetheless, to the extent the Legislature or, as applied to non-exempt employees, the Commission in its authorized wage orders has prohibited the use of certain expenses in determining wages due an employee, economic reality must yield to regulatory imperative."

Although the court did not halt wage litigation from expanding into bonus plans, the court slowed it considerably. It pointed out that the decision in *Kerr's Catering* was based on wage orders applicable only to employees who were not exempt from existing wage orders. Thus executive, professional or administrative employees may continue to be paid under bonuses calculated using cost items like theft or breakage. No bonus deductions would be permitted for nonexempt employees, those typically paid by the hour.

The sole exception to this are costs of workers' compensation premiums, where the court viewed the broad provisions of Labor Code section 3751 as applying to bonuses for all employees.

Both sides are likely to continue the fight. In a petition for rehearing, the employees' attorney challenged the court's "bright line" which distinguishing between exempt and nonexempt employees. The company has opposed this petition, but in doing so took strong issue with the Court's underlying decision. Both sides are likely to petition for the Supreme Court's review.

In the meantime, what is an employer to do? Can an employer create a bonus plan that takes into account costs or losses? Unless and until the Supreme Court intervenes, the answer will be murky. Employers who rely upon *Ralphs* might limit bonus plans to more highly paid exempt employees. Some may point out that this is an unintended consequence for a law designed to protect employee wages.

In recent years, employees increasingly have shared profits at all levels of its work force. That trend may be hard to sustain in the face of possible class action exposure for improper bonus calculations. Employers may take a safer course and limit bonuses to its more highly compensated employees. Certainly any bonus plan that factors in costs for workers' compensation claims or premiums will be at heightened risk.

For now, employers should proceed with caution. Bonus plans that deduct for a bonus costs or losses, especially those outside the control of an employee are more likely to be attacked. Discretionary, performance behavior-based factors are probably less vulnerable. Ironically, a more subjective standard is likely to be less vulnerable than those based on standard accounting principles.

Employers sometimes feel like it is harder and harder to pay an employee his or her wages legally. The festering dispute over bonus pay won't make that impression go away any time soon.