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Incentive Plans Merit Closer Scrutiny Under New Case Law.

RALPHS GROCERY V. SUPERIOR COURT: DOES THIS SIGNAL THE END OF INCENTIVE COMPENSATION PLANS FOR EMPLOYEES?

By J. Kevin Lilly

Employers have long used corporate bonus plans as a popular means of sharing profit and attracting and retaining quality employees. Many profit sharing plans have been designed to encourage workplace goals such as increased sales, control of costs, or even workplace safety and litigation avoidance. Employees whose business units are successful in these areas can earn increased bonus compensation for achieving goals as set by management. Other corporate plans are more generic, simply sharing portions of the net profit of the enterprise.

In the past, California courts generally regarded an employer as "free to . . . use any formula that it desired" to calculate a bonus. Gradually, however, the courts' interpretations of the wage and hour provisions of the California Labor Code – designed to protect employee wages – began to encroach on the area of incentive compensation. Whether intended or not, the result is that wage and hour laws have been placed on a steady collision course with employee bonus plans, making it increasingly difficult for employers maintain such plans as effective employment tools.

The most recent example of this discord is the California Court of Appeal's decision in *Ralphs Grocery Co. v. Superior Court* ("*Ralphs Grocery*"). In this case, decided in October 2003, the court held that Ralphs's incentive compensation plan violated the Labor Code because the calculation of employee bonuses was based on a formula that considered the store's profits and certain losses, including cash shortages, merchandise shortages, shrinkage, and workers' compensation costs.

STATUTORY PROTECTION OF WAGES

California employees enjoy various forms of protection of their wages under the California Labor Code and the applicable regulations and wage orders issued by the Industrial Welfare Commission (IWC). For example, Labor Code Section 221 prohibits "rebates" of wages back to an employer by providing that it is "unlawful for any employer to collect or receive from an employee any part of wages theretofore paid by said employer to said employee." Similarly, the IWC wage orders prohibit employers from making certain deductions from wages. The wage orders provide: "No employer shall make any deduction from the wage or require any reimbursement from an employee for any cash shortage, breakage, or loss of equipment, unless it can be shown that the shortage, breakage, or loss is caused by a dishonest or willful act, or by the gross negligence of the employee."

Finally, Labor Code Section 3751 contains a broad prohibition against recovering any costs associated with workers' compensation, providing that no employer "shall exact or receive from any employee any contribution, or make or take any deduction from the earnings of any employee, either directly or indirectly, to cover the whole or any part of the cost of compensation under this division." Employers who violate this provision are subject to criminal penalties.

CALIFORNIA CASES INTERPRETING THE WAGE PROTECTION LAWS

Prior to the *Ralphs Grocery* case, the watershed case on deductions from employee wages has been the California Supreme Court's 1962 decision in *Kerr's Catering Service v. Department of Indus. Relations* (DIR). In that case, employees were paid a base salary plus a 15 percent sales commission. Under the employer's plan, the commission amounts were subject to a reduction for cash and inventory shortages during the month. The DIR challenged this commission scheme under the applicable wage order, which expressly prohibited deductions from wages for expenses due to cash shortages, breakage or loss of equipment, unless such expense was due to the dishonest or willful act, or the culpable negligence, of the employee. The Supreme Court agreed, holding that "cash shortages should be borne as an expense of management."

Seventeen years later, a California Court of Appeal in *Quillian v. Lion Oil Co.* similarly decided that a manager's monthly incentive bonus—designed to increase sales and minimize cash and merchandise shortages—was unlawful because the bonus amount, which was based on the total sales less any shortages during the particular month, essentially made the plaintiff a guarantor of the employer's business losses. Since *Quillian*, most employers have assumed that deductions from wages of any California employee for employer expenses would violate California law under both *Kerr's Catering* and *Quillian.*

In 1995, another Court of Appeal in *Hudgins v. Neiman Marcus Group, Inc.*, held that a commission program violated Labor Code Section 221 because it unlawfully deducted a "prorated share of the commissions deemed to have been paid on unidentified returns received in the sales associate's home base during the pay period."

THE *RALPHS GROCERY* CASE AND THE DISTINCTION BETWEEN EXEMPT AND NONEXEMPT EMPLOYEES

It was against this backdrop that the Court of Appeal decided *Ralphs Grocery*. Unlike in the previous cases, the *Ralphs Grocery* court drew a distinction between exempt and nonexempt employees in deciding whether the employer's bonus compensation plan was authorized under the state wage and hour laws. The two significant holdings of the decision are:

1. *As to non-exempt employees only*, calculating an incentive bonus based on profitability by taking into account revenues *and* store expenses may give rise to a cause of action for violation of the California wage orders. The court held, however, that this type of bonus plan is permissible as it applies to *exempt employees*.
2. A plaintiff *can* state a claim for violation of Labor Code Section 3751, which prohibits employers from directly or indirectly holding their employees accountable for workers' compensation expense, *against an employer whose bonus plan includes a "charge for workers' compensation costs.*" This claim applies to *all* employees.

Because the *Ralphs Grocery* court took a different approach than that taken in earlier cases, including the well-known decisions in *Kerr's Catering, Quillian* and *Hudgins*, the decision is already controversial. Both parties are expected to seek review by the California Supreme Court.

RECOMMENDATIONS FOR EMPLOYERS

It is fair to say that the law on bonuses in California is in a state of acute uncertainty. Unfortunately, given this lack of clarity, it is impossible to give advice as to the precise kind of bonus that will not be vulnerable to challenge.

The most conservative approach is to assume that the "safe harbor" for exempt employees in *Ralphs Grocery* will not survive, and that either the California Supreme Court will adopt the reasoning in *Quillian*, or that no definitive decision will exist, leaving employers open to litigation in the absence of a clear standard. In that event, there is no real case guidance as to what kind of a bonus would survive an attack. Although it is not yet possible to design a "bullet proof" approach, the following various approaches to employee bonuses and how they might be impacted by this line of cases.

1. Bonuses based upon gross sales or revenue

A bonus that is not reduced by any cost factor will not implicate the policies in *Kerr's Catering* or *Quillian*. Accordingly, a plan that rewards staff for meeting specified sales targets should be acceptable. However, any *deductions* from sales numbers, might lead to a claim that the bonus is unlawful because it takes away wages for reasons beyond the employee's control.

2. Bonuses based upon behavioral criteria set by management

A bonus, for example, that rewards behavioral metrics or observations on a manager's actual job performance would appear not to be implicated in *Ralphs Grocery*. However, a bonus that "punishes" managers for unusual or protected costs might be questioned. Most risky would be, for example, a bonus that rewards managers for low accident or workers' compensation claims.

3. Profit Sharing Plans

Ralphs Grocery should not affect profit sharing plans constructed under the Employee Retirement Income Security Act (ERISA). ERISA authorizes employers to implement "profit-sharing" plans as pension plans for employees. It does not restrict how profits are calculated except that amounts accrued under a profit sharing plan must be determined by a "definite predetermined formula." 26 U.S.C. § 401(a)(27). However, non-ERISA plans that attempt to "share" profit by assigning a bonus mathematically related to the profit of the company, or portion of the company, will be subject to the *Ralphs Grocery* issues. Thus, line items of a profit calculation that relate to workers' compensation will be vulnerable to attack under Labor Code Section 3751. With respect to non-exempt employees, a profit sharing plan that deducts a wide range of business costs is vulnerable under the law as it currently stands in California.

4. Discretionary Bonuses

Discretionary bonuses, at least under the federal standard, are sums paid in recognition of services performed in a given period if: (a) both the fact and the amount of the payment are determined at the sole discretion of management at the end of the period, and (b) the payments are not pursuant to any prior contract, agreement or promise causing the employee to expect such payments regularly. To avoid the *Ralphs Grocery* issues with a discretionary bonus, the employer would have to avoid creating a plan in which payments are stated and determinable at the beginning of the bonus period. In that sense, a "true discretionary bonus" would not be barred by *Kerr's Catering* and *Quillian*.

5. Using a "Line Item" Approach

The employee-plaintiffs in *Ralphs Grocery* ultimately decided to challenge only the "deductions for cash shortages, merchandise shortages and workers' compensation claims," and dropped their broader allegations that attempted to challenge the deductions for other losses beyond plaintiffs' control. This might suggest that an employer can save a bonus plan by simply deleting deductions based upon the kind of expenses that the courts have clearly held to be unlawful deductions from wages. This approach is certainly *required* for any expenses for workers' compensation insurance. Employers must also be wary of bonus plans which reward employees for any statistical measure of success related to workplace injuries. A safer course of action might be to grant bonuses to employees who meet specified metrics for safety compliance, *e.g.*, scores on safety audits. Given the huge significance of workers' compensation costs for California employers, this must seem a highly unsatisfactory and illogical limitation. However, under the law, to create compensation incentives tied to a reduction in workers' compensation costs—directly or indirectly—is an extraordinarily high-risk venture.

There are other expense items that appear to be most likely to come under scrutiny by plaintiffs' class action lawyers. The following is a list, which should not be regarded as exclusive, including cost items that most likely would result in challenges to bonus calculations under a *Ralphs Grocery* rationale:

- Breakage, theft, or "shrinkage" losses
- Third party tort claims
- Employee overtime costs
- Casualty losses
- Cash shortages

Thus, at least pending more definitive guidance by the Supreme Court, an employer might at least reduce its "litigation profile" by excluding from bonus calculations cost items that appear similar to those that California courts have already disapproved. Such a plan might allow bonuses based on net sales or other line items where the cost is associated with the revenue item. Other cost items, like facility rent, might also be included. However, it would be easy to see how almost any cost item might be converted to an alleged unlawful deduction from wages.

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