ASAP™ A Littler Mendelson **Time Sensitive** Newsletter

in this issue:

AUGUST 2007

In *Prachasaisoradej v. Ralphs Grocery Company*, No. S128576 (Cal. Aug. 23, 2007), the California Supreme Court ruled that employers may lawfully use net-profit based incentive plans to provide supplemental income to employees. The court leaves in place earlier decisions that found some deductions of expenses from incentive income to be unlawful, leaving unanswered questions about how widely it will apply the principles it announced.

California Edition — *A Littler Mendelson California-specific Newsletter*

Prachasaisoradej v. Ralphs Grocery Company – Employers and Employees Can Share in Profits

By R. Brian Dixon and Diane L. Kimberlin

In *Prachasaisoradej v. Ralphs*,[1] No. S128576 (Cal. Aug. 23, 2007), a narrow majority of the California Supreme Court ruled that employers may lawfully use net-profit based incentive plans to compensate employees. The *Ralphs* decision presents a balancing point to a line of cases that had concluded that some types of deductions from other, albeit sometimes similar, forms of incentive compensation were invalid. The lawfulness of compensation plans that fall on the continuum at points between these earlier cases and the *Ralphs* decision is not clear.

The bonus plan at issue was based on target profit and target bonus figures. As the amount of actual profits increased in relation to the bonus plan target profits, the percent of the target bonus paid was increased. In calculating the profit, "pursuant to normal concepts of profitability," revenue of the store was subject to reduction for, among other expenses, workers' compensation claims, cash shortages, merchandise shortages or shrinkage, and the costs of nonemployee tort claims, which were not caused by the willful or dishonest acts or gross negligence of the employees. Other deductions presumably included the costs of goods sold, utilities and the renting of the premises.

The California Court of Appeal in *Ralphs* had followed an earlier decision concerning the same employer and concluded that incorporating certain challenged costs in the profit formula was unlawful.[2] The court of appeal ruled that the profit calculation in the incentive plan resulted in unlawful deductions from the wages of all employees because workers' compensation costs were deducted when calculating net profits. Section 3751 of the California Labor Code[3] prohibits an employer from taking any contribution from employees, or deducting any amount from their pay, *either directly or indirectly*, to cover any part of the cost of workers' compensation. Deductions that fall within section 3751 cannot be taken from the wages of exempt or nonexempt employees.

The court of appeal also ruled that the profit calculation in the incentive plan resulted in unlawful deductions from wages of non-exempt, hourly paid employees because deductions were made for cash and merchandise shortages and other losses, which were not the result of the willful or dishonest acts or gross negligence of the employees. Section 8 of the applicable Wage Order prohibits such deductions with respect to employees who receive overtime, but does not prohibit such deductions with respect to overtime exempt managers.[4] In addition, the plaintiff in the case relied on sections 221[5] and 400[6] of the Labor Code. Both section 221 and 400 limit deductions from the wages of both

[1] Littler Mendelson served as counsel for the California Grocers Association as Amicus Curiae.

[2] *Ralphs Grocery Co. v. Superior Ct. (Swanson)*, 112 Cal. App. 4th 1090 (2003).

[3] All statutory citations are to the California Labor Code unless otherwise noted.

[4] 8 Cal. Code Regs. § 11070, ¶ 8.

[5] Section 221 of the California Labor Code provides that, with certain exceptions, an employer may not collect or receive back from an employee any part of the wages theretofore paid.

[6] Section 400 and the following sections of the California Labor Code limit the circumstances in which an employer can require a cash bond from an employee as security for losses that the employee might cause.

exempt and nonexempt employees.[7] Because the incentive plan was found to violate the Labor Code, it was also found to be an unfair business practice in violation of section 17200 of the Business and Professions Code.

In reversing the court of appeal, the Supreme Court majority pointed to several factors that showed the bonus did not unlawfully compromise any wage payment obligation. First, the majority emphasized that the deduction was not made from a specifically defined wage that the employee earned through his or her individual efforts. Second, the majority emphasized that the reductions in the amount of the bonus were not made from an individually calculated incentive as a dollar for dollar recovery of costs. Third, the court emphasized that employees received their specifically promised regular hourly wages and salaries during the period that was used to measure the profit of the store, and that the regular wages were not subject to any allegedly impermissible deductions. The court noted that the bonus was an amount over and above the employees' regular pay. Fourth, the court pointed out that the promised bonus was the end result of the calculation process. The court observed that the employer absorbed all of the costs prior to any distribution of profits.

The first of these factors allowed the court to distinguish one of the earlier cases. In *Kerr's Catering Service v. Department of Industrial Relations*,[8] the deductions at issue were made from commissions that resulted from the individual efforts of the employees and were dollar for dollar in the amount of the employer's losses.

The majority's factors do less well to distinguish the decision in *Hudgins v. Neiman Marcus Group, Inc.*,[9] where the deductions were from commissions earned by the efforts of an individual employee, but the deductions were attributable to returns of merchandise where the employee making the sale could not be determined. Nor was the amount deducted in *Hudgins* directly related to the loss incurred by the employer, as the deductions were only in the amount of the commissions paid on returned goods and did not include the cost of re-stocking or damage to the returned goods.

The case which is most difficult for the court to distinguish is *Quillian v. Lion Oil Co.*,[10] where the "tentative" bonus was calculated as a percentage of the revenue of the gas stations for which the plaintiff manager was responsible, rather than on the basis of the individual manager's sales efforts. Although the California Supreme Court characterized the payment in all three cases as "essentially" a commission, the bonus formula in *Quillian* could be characterized as akin to a profit-based incentive. The deductions made, however, were in the full dollar amount of cash shortages that were not the fault of the manager. Because the factors cited by the majority do not entirely distinguish *Quillian*, the result in Ralphs may come to be read as implicitly overruling *Quillian*. This inconsistency *might* be read to mean that a compensation plan may be lawful even though some of the "distinguishing" factors identified by the court in *Ralphs* are not present.

Echoing a concern of many employers, the court noted that the plaintiff's theory as to what constitutes a "deduction" from a wage could be applied to render any expenses in a profit calculation unlawful. Under the plaintiff's theories, impermissible deductions from a profit calculation could include the utility bill as well as the costs of workers' compensation coverage, and could include the rent as well as cash and merchandise shortages. The majority recognized that, if the plaintiff's theory was taken to its logical end, all profit-based plans would be rendered unlawful. The court found no legal basis for such a ruling. It determined, instead, in the circumstances at issue, that an employee's protected wages were only determined after all the calculations required under the bonus plan were completed.

The court's emphasis on the bonus as something supplemental and not earned by any individual employee's efforts brings the court close to concluding that the bonus was not, in fact a wage. That conclusion has been drawn by a number of eastern states with respect to profit-based incentives. Such a conclusion relieves an employer of the obligation to comply with the statutes regarding wage payments, but does not excuse an employer from its contractual obligations.

The dissent in *Ralphs* focuses almost entirely on the deduction of workers' compensation costs from revenues in calculating the bonus. The dissent poses a difficult question for the majority, asking how the deduction of workers' compensation costs from gross profit can be characterized as something other than at least an "indirect" recovery, "in part," of workers' compensation costs in violation of section 3751. The dissent stops short of asking why the same logic does not apply to render impermissible the subtraction of cash shortages and other losses that were also at issue. By not asking that question, the dissent essentially concedes the majority's essential point, that the subtraction of other costs from revenues was too far removed from the ultimate result of the bonus calculation to be considered deductions at all.

The dissent's second major point, that the deduction of workers' compensation costs would discourage employees from filing workers' compensation claims, was speculative. The assertion was not based on any quantification of the effect of subtracting workers' compensation costs on the incentive calculation. The majority's rejoinder, that such deductions might have the beneficial effect of encouraging safety, was likewise speculative.

In sum, *Ralphs* affirms the interest of an employer in providing a profit-based incentive to employees. Exactly how far the decision goes in allowing employers to use derivatives of profit-based formulas will remain to be seen.

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[7] Deductions for purposes other than losses are regulated by section 224 of the California Labor Code.

[8] 57 Cal.2d 319 (1962).

[9] 34 Cal. App. 4th 1109 (1995).

[10] 96 Cal. App. 3d 156 (1979).