How Do You Recapture Debt From An Employee's Final Paycheck? Very Carefully

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Employers continue to be challenged with claims from terminated employees who received payroll deductions for debts they owed the employer. In a recent case employees brought a collective action in a California federal court seeking remedies for violations of California law and the federal Fair Labor Standards Act (FLSA) for deductions taken from their final pay checks for debt balances. The federal court ruled in favor of the company on all claims. *Ward v. Costco Wholesale Corporation.*

The Background
As in many states, the law governing deductions from wages is strictly regulated in California. Labor Code §221 generally prohibits deducting any part of an employee's previously earned wages from a pay check unless special circumstances apply. Some exceptions include withholdings for: 1) state or federally required or authorized deductions (e.g., taxes); 2) deductions for insurance premiums, hospital or medical dues, or other deductions arrived at by collective bargaining or "pursuant to wage agreement or statute," that are authorized in writing by the employee; and 3) deductions to cover health and welfare, or pension plan contributions.

In a 2008 opinion, the California Labor Commissioner made clear that deductions *on a regular paycheck* during the course of employment, not amounting to a rebate or deduction from the standard wage arrived at by collective bargaining or pursuant to wage agreement or statute, are lawful, but must be authorized in writing by the employee.

But with regard to a *final* paycheck, a different rule is applied. In the same 2008 opinion, the Labor Commissioner wrote that deductions from an employee's final paycheck for debts owed to the employer are prohibited, even with prior written authorization. The Commissioner relied primarily on *Barnhill v. Robert Saunders & Co.* in which a state court ruled that deductions made by the employer from an employee's final paycheck for the balance owed on a debt constituted illegal self help.

In the *Barnhill* case, the employee borrowed money and executed a promissory note to repay the debt in installments at 10% interest. The employee agreed orally to deductions by installment payments only, although the note contained language that the debt could be collected "by payroll deduction or upon demand." Upon termination, the employee received a zero check because the employer had deducted from her wages the balance owing as a "set off" against the personal money loan.

The Labor Commissioner explained, "*Barnhill* does not hold that employers are prohibited from making periodic set offs of wages (other than in final paychecks) to repay a loan owed to the employer where the employee has signed an express written consent to periodic set offs from wages. The decision focuses on the balloon payment deducted from the employee's final paycheck, and concludes that such set off violates Labor Code §201."

A Clarification

In *Ward v. Costco Wholesale Corporation*, Costco instituted for its employees a "guaranteed credit-card program" which allowed employees to make purchases at Costco using a credit card issued by a third party. Costco guaranteed the credit card if the employees defaulted. Costco made sure that the employees executed authorization agreements permitting it to deduct an amount equal to the employee's credit-card balance from final paychecks issued to the employees, and further, authorized installment payments from their paychecks received during employment.

In a bench trial, the federal judge ruled that Costco lawfully withheld from wages on its employees' final paychecks the balances due for their personal expenditures on their Costco credit cards. Critical to the court's decision was: "[f]or all Plaintiffs, the credit-card deduction was taken from a check that also included accrued leave pay, and the credit-card deduction was less than the amount of the leave pay in all instances." The leave pay was identified by the employer as pay for "non-work" hours.

In effect, the court justified the deduction of the full balance by differentiating between compensation due for "non-work" hours and compensation owed for hours worked. Because all deductions made by Costco in each case were less than the "non-work" or leave pay that was owed as final wages, there was no deduction that brought the employees' compensation below the state or federal minimum wage. Having failed to establish any violation, the federal and state claims were dismissed, including claims for liquidated damages and "waiting-time" penalties.

The federal decision is not binding on how state courts may interpret state law given these facts, although state courts may view the federal decision as persuasive. Furthermore, the case may be appealed to the U.S. Court of Appeals for the 9th Circuit. It remains uncertain how California courts would rule on the issue. Paid leave is not considered "hours worked" for purposes of determining an employee's regular rate for overtime purposes, nor would paid leave be considered as a credit toward the minimum wage or "standard wage" owed by an employer for hours worked under the contract of employment. That being said, paid leave benefits still are considered "wages" under California law.

So What's An Employer To Do?

The issue of deductions from wages continues to be vigorously debated by employee advocates.

Plaintiff attorneys occasionally misinterpret as an "unlawful deduction" what amounts only to a reconciliation on a wage-payment calculation which actually may be permissible in California in a carefully-drafted agreement, such as crediting a draw against commissions owed (effectively reducing the net commission paid), or charging back a draw or advance paid on a commission that turns out not to be earned and payable under the terms of the employment agreement (effectively recapturing the entire advanced payment).[1]

What remains clear is that, in those instances when *deductions* from wages are permitted, an employer should obtain a written authorization for the deduction.[2] If the compensation agreement involves merely advances or draws on commissions, the arrangement should be carefully memorialized in writing so that the employee understands fully how the commission is calculated, what conditions apply for it to be earned and payable, and to what extent excess draws over commissions are owed and recoverable as debts following termination.

Even if situations arise when you determine that it is too risky to take a deduction from earned wages, other remedies exist to recover those employee debts or obligations through separate civil actions, including small claims court, which is a relatively inexpensive route for attempting to recover such debts.

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[1] In California, an employer can pay draws against commissions that may be recaptured or reconciled in the pay period when the commissions are earned as long as the employee is working under a *bona fide* commission agreement and the minimum wage requirements are satisfied for each pay period. California courts acknowledge the enforceability of properly-drafted employment agreements, including recapturing advanced commissions by charge backs from future advanced wages in a compensation scheme.

[2] California Wage Orders permit a deduction from an employee's wages for losses for "any cash shortage, breakage, or loss of equipment" if the employer can prove that the loss was "caused by a dishonest or willful act, or by gross negligence of the employee." *See, e.g.*, 8 Cal. Code of Regs. § 11070(8). This implicitly permits a unilateral deduction because the regulation is silent regarding whether a signed authorization also is required. Nevertheless, the safer course would be to require such a signed authorization. All Wage Order provisions are subject to judicial review to determine whether they are in conformity with the Labor Code.

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