California Court Decision Affecting Profit-Based Bonuses

Insights
10.23.03

On October 23, 2003, the California Court of Appeal held in *Ralphs Grocery Co. v. Superior Court*, that a profitability-based bonus plan for managers of a business that takes into account workers' compensation costs as an element of the net profit of the business is illegal. The court also held that profit-based bonus plans for non-exempt employees that take into account cash shortages and/or merchandise shrinkage are also illegal.

A former Ralphs store manager sued, on behalf of a class of managers and other employees, alleging that Ralphs' incentive bonus plan based on net store profit is unlawful because it takes into account certain expense items in computing store profit for which an employer may not hold employees responsible in California - namely workers' compensation costs and cash shortages and merchandise shrinkage. Ralphs moved to dismiss the case, but both the trial court and the Court of Appeal denied the motion. The appellate court recognized the popularity and effectiveness of profit-based bonus plans, but it cited Section 3751 of the California Labor Code, which prohibits employers from making any deduction, directly or indirectly, from the earnings of an employee to cover workers' compensation costs. Maintaining that "economic reality must yield to regulatory imperative," the court held that a bonus plan that includes workers' compensation costs in calculating net profit is unlawful, whether it involves exempt or non-exempt employees.

The court went on to hold that as the Industrial Welfare Commission's Wage Orders prohibit deductions from wages of non-exempt employees for cash shortages and merchandise shrinkage not resulting from gross negligence or dishonesty of the employee, a profit-based bonus plan for non-exempt employees cannot lawfully take those items into account in computing net profits.

This case will likely be appealed to the California Supreme Court. Meanwhile, it presents significant exposure for employers that pay managers a bonus or commission based on the profitability of the business, or a department or unit thereof, where workers' compensation costs are included as an expense item in determining profitability. In addition, the court held that employers who have such bonus plans may be deemed to have failed to pay all wages when due, subjecting such employers to the potential for 30 days of pay as a "waiting time penalty" for each affected employee.

Legislation has been introduced in the California Senate to overturn this decision by amending Section 3751 of the California Labor Code. The bill, S.B. 6, is being considered as part of the

Legislature's current special session to consider workers' compensation reform. Click below for a link to the bill:

Letters in support of this legislation should be directed, as soon as possible, to:

Honorable Ross Johnson
California State Senate
State Capitol, Room 3063
Sacramento, CA95814

(fax: 916/445-9263)

Meanwhile, employers should review all of their profit-based bonus plans to determine if they might be impacted by this court decision.