Affirmed Incentive

By Diane Kimberlin

On Aug. 23, the California Supreme Court issued its long-awaited decision in *Prachasaisoradej v. Ralphs Grocery Co. Inc.*, 2007 Cal. LEXIS 8909. Deciding what it characterized as "a significant question of California wage law," the court held that Ralphs' profit-based incentive compensation plan ("ICP") was entirely lawful, and that the subtraction of expenses from revenues to determine the profit used in the ICP's calculation of bonuses did not constitute an unlawful deduction from the wages of employees eligible to participate in the plan.

The court reversed the appellate decision under review, and disapproved of the decision *Ralphs Grocery Co. v. Superior Court*, (*Swanson*), 112 Cal. App. 4th 1090 (2003), a case brought by a different plaintiff testing Ralphs' ICP. The court's decision ended years of uncertainty, generated by *Swanson*, by holding that profit-based pay plans are lawful — at least those that supplement employees' regular wages and are based on profit generated by the collective efforts of employees.

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The *Swanson* court had ruled that deducting certain costs from revenues to arrive at the profits that formed the basis for incentive bonuses was the legal equivalent of deducting those amounts from an employee's paycheck. That ruling caused great concern to employers, who are generally prohibited from deducting expenses and costs of doing business from their employees' pay. Fearing that any profit-based plan might become the subject of class action litigation, many employers sought to protect themselves by altering their incentive pay plans to eliminate bonuses based on profits. The California Supreme Court's decision in *Prachasaisoradej* returns greater flexibility to employers, and should greatly diminish fears that profit-based bonus plans will make them targets for class action litigation.

Jeopardizing Profit

The court directly addressed the concern that *Swanson* put all profit-based plans in jeopardy. It noted that if it were an unlawful wage deduction to subtract the challenged expenses from revenues in order to determine the profits on which bonuses were based, then it would be similarly unlawful to subtract any expense, the utility bill, rent, or cost of goods sold, from the store revenues in those calculations. Noting the plaintiff's statement at oral argument that employers could compensate for the elimination of certain expenses from the profit calculation by adjusting the percentage of profits paid under the ICP, the court found "nothing in the wage-protection laws, or the policies they promote, that requires such meaningless figure-juggling."

One of the subtexts to the plaintiff's arguments in both *Swanson* and *Prachasaisoradej* was that the ICPs in question did not guarantee an individual employee a particular payment, even if the employee performed his or her own job as expected. The unspoken suggestion seemed to be that such uncertainty of outcome was impermissible. That sort of uncertainty is inherent, however, in profit-based compensation plans. Employers and employees alike share the possibility of benefiting from a good year and being disappointed in a bad year.

Indeed, the sense of partnership accompanying such a shared fate is one of the hallmarks of profit-based plans, which are valued by employers for fostering goodwill and a sense of teamwork. The court directly addressed the uncertain nature of profit-based compensation plans and found that it was not enough to cause the ICP to run afoul of the law. "To hold otherwise would make every kind of achievement-based supplementary incentive compensation system, whether based on individual or overall business performance, illegal."

Ralphs' ICP offered bonuses based on a comparison of a store's financial performance to the financial targets set for that store. The court determined that figuring in "ordinary business expenses, such as storewide workers' compensation costs, and storewide cash and merchandise losses," to arrive at "normal concepts of profitability," did not render the ICP illegal. Noting that Ralphs had "fully absorbed" the expenses at issue before determining what "profits to share with its eligible employees in addition to their normal wages," the court rejected the plaintiff's claims that the ICP exacted unlawful "deductions" from employee wages.

The plaintiff challenged the ICP on the ground that including certain allegedly forbidden costs in determining its profits for purposes of the ICP violated several provisions of the California Labor Code, as well as portions of the Wage Orders issued by California's Industrial Welfare Commission.

California Labor Code Section 3751 was a major focus in the dispute and the source of greatest concern among employers. Section 3751 makes it unlawful for an employer to charge its employees "directly or indirectly" for any portion of the costs of providing workers' compensation benefits. Section 3751 protects all employees, both those who are exempt from overtime pay requirements and nonexempt employees paid on an hourly basis. The plaintiff alleged that including the costs of workers' compensation claims among expenses to be deducted from revenue in determining a store's financial performance for purposes of determining payouts under the ICP amounted to an indirect assessment against employees for the cost of providing benefits.

Other challenges to the ICP were based on Labor Code Sections 221 and 400 through 410, and on the wage order for the mercantile industry found at Cal. Code Regs., tit. 8, Section 11070, subd. 8. Section 221 is an "anti-kickback" provision, which prohibits employers from taking back any portion of a wage "theretofore paid" to the employee. Sections 400 through 410 govern an employer's ability to require an employee to post cash or property as a bond. The provisions of the wage order at issue apply to nonexempt employees and prohibit deductions from wages or required reimbursement by the 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." See wage order at subd. 2(O).

Unlawful Deductions

The plaintiff in this case relied on a trio of earlier cases, *Kerr's Catering Service v. Department of Industrial Relations,* 57 Cal. 2d 309 (1962), *Quillian v. Lion Oil Company,* 96 Cal. App. 3d 156 (1979) and *Hudgins v. Nieman Marcus Group Inc.,* 34 Cal. App. 4th 1109 (1995), to support his theory that subtracting the challenged expenses from revenues was an unlawful deduction from wages.

The court distinguished these cases. In the court's view, the pay practices in question in these earlier cases were essentially commission-based and derived from the employee's personal effort, with the employee's pay subjected to deductions for the full dollar value of merchandise and cash losses, regardless of the employee's fault in incurring those losses.

In contrast, the court emphasized that each participant in the ICP was paid, "as full compensation for his individual work," an agreed-upon sum that did not vary with the store's financial fortunes. The ICP rewarded certain employees for their "cooperative and collective contributions to the profitable performance of their stores" by sharing a portion of the profits earned at the store. The court determined that an employee's wage, which was protected from unlawful deductions, was determined only after the store determined its profit or loss figures, compared them to targets, and calculated whether and, if so, how much, money was owed under the terms of the ICP.

While the court distinguished the trio of cases relied upon by the plaintiff by saying they were essentially commissions, the *Quillian* case is not as easily distinguished as *Kerr's* and *Hudgins*. The *Quillian* case involved a pay plan whereby the manager of two gas stations received a bonus that was "tentatively" calculated as a percentage of the gasoline and other items sold at the two stations. The revenues used in the bonus calculations included sales made by persons other than the manager. After calculating the "tentative" bonus, the employer in *Quillian* deducted the full dollar value of shrink or other losses that were not the fault of the manager.

The court in *Quillian* emphatically rejected the employer's argument that the subtraction of these costs from the "tentative" bonus was just the last step in the calculation of the bonus and was not a deduction from the bonus itself. That is not entirely different from the sequencing of calculations at issue in the administration of Ralphs' ICP. These similarities suggest several points of caution for employers who may wish to redesign their compensation plans in light of the decision in *Prachasaisoradej.*

Future Precautions

While the court did not overrule or disapprove of the *Quillian* decision, the logic of that earlier case has been undermined. It remains to be seen just how far the court will go in applying the principles it announced in *Prachasaisoradej* to situations that are closer to those in *Quillian* than they are to the operations of the Ralphs ICP. Employers will want to consult their legal counsel if they are considering changes to an incentive compensation plan, especially one that is not a "supplement" to the employees' regular compensation, or is not based on the "collective" efforts of employees.

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