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New Court Ruling Prompts Employers To Review Their Profitability-Based Bonus Plans

Ralphs Grocery Company recently paid its store-level managers a bonus based upon store profitability. In calculating store profits, Ralphs subtracted expense items such as the cost of workers' compensation claims and cash shortages. On October 23, 2003, the California Court of Appeal ruled that while certain expense items, even those beyond the store manager's control, can lawfully be considered in profit-based bonus programs, deducting the cost of workers' compensation claims and cash shortages in determining the store's profitability is illegal. Ralphs Grocery Company v. Superior Court (Swanson), Case No. B168257. The Court relied in part on Labor Code Section 3751(a) which states that no employees' wages can be reduced for the cost of workers compensation claims. The Court also relied on Wage Order 7-2001, applicable to the mercantile industry, which states that no deduction from wages can be made for any cash shortage, breakage, or loss of equipment unless caused by a dishonest, willful, or grossly negligent act of the employee. Because Wage Order 7-2001 does not apply to exempt managerial and administrative employees, the Court held that bonus calculations which consider such shortages or loss can be appropriate, but only if the employee receiving the bonus truly qualifies as exempt.

Ralphs argued that the bonus payment was legal because no deductions were made from the actual bonus paid but merely factored into the calculation to compute the bonus amount. The Court rejected this argument. Relying on Quillan v. Lion Oil Co., 96 Cal. App. 3d 145, 163 (1979), the Court held that the timing of the deduction is immaterial; if the employee carries the burden for the loss, it must be considered a reduction from wages.

This decision has far-reaching implications. It should prompt all employers who pay bonuses to their employees to review their bonus plans. Although Wage Order 7-2001 only applies to the mercantile industry, most California employers are covered by wage orders containing an identical prohibition on deductions for shortage, breakage or loss. Labor Code Section 3751(a), which states that deductions for workers' compensation costs are improper, is one of general applicability throughout California regardless of the wage order under which the employer falls. Thus, while the Ralphs decision clearly establishes that bonuses based on profitability can take certain expenses into account, California employers must ensure that impermissible expenses, such as workers' compensation costs and, in the case of bonuses paid to non-exempt employees, the cost of shortage, breakage or loss not caused by the employees dishonest, willful or grossly negligent, are clearly excluded from the bonus calculation.

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