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California Employers Can Factor Cash and Merchandise Shortages Into Bonus Calculations For Exempt But Not for Non-Exempt Employees

On October 23, 2003, a California appellate court made several significant rulings regarding the permissible structure of employee bonus plans. In *Ralph's Grocery Company v. Superior Court*, 2003 Cal. App. LEXIS 1592, the court addressed what factors California employers can and cannot incorporate into profit-based bonus plans:

- ◆ A profit-based bonus plan, which includes operating costs as a factor, cannot rely on workers' compensation costs, regardless of whether the bonus is for an exempt or a non-exempt employee.
- ◆ Similarly, a bonus plan that includes cash and merchandise shortages as factors is invalid insofar as non-exempt employees are concerned. (And remember that, in California, managers classified as exempt often have turned out not to be exempt.)
- ◆ Employers can rely on cash and merchandise shortages in calculating bonuses for employees who are truly exempt.

The plaintiff in *Ralph's* was a former store manager who sued on behalf of himself and a class of store managers. The bonus plan he challenged used a "net profit" type of formula that deducted for cash shortages, merchandise shortages, and workers' compensation costs. When the employer moved to dismiss the complaint, the trial court ruled for the plaintiff. *Ralph's* petitioned to the Court of Appeal for a writ of mandate. Usually those petitions are summarily denied. In this case, however, the Court of Appeal wrote an opinion, presumably because the issues involved are both novel and important to the business community in California.

Pay Deductions Based on Workers' Compensation Costs Are Forbidden

A California Labor Code provision specifically forbids employers to "make or take any deduction from the earnings of any employee, either directly or indirectly, to cover the whole or any part of the cost of [workers'] compensation." Cal. Lab. Code § 3751(a). While acknowledging that creating incentives for managers to reduce workplace injuries and resulting workers' compensation costs was consistent with the goal of the workers' compensation system, the court reasoned that the "plain language" of section 3751 forbade *Ralph's* to consider workers' compensation costs in calculating management bonuses.

While section 3751 traditionally has been interpreted as prohibiting a pay reduction for an injured worker, no court previously had held that overall workers' compensation premium costs must be ignored in a profit-based bonus plan. Applied literally and broadly, section 3751 as interpreted by the *Ralph's* court would invalidate countless profit-based bonus plans, including those for CEOs of large corporations.

Employer Deductions Based on Cash and Merchandise Shortages Are Permitted for Exempt Employees, But Not for Non-Exempt Employees

Section 8 of the California wage orders prohibits deductions from wages 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." This section of the wage orders applies only to non-exempt employees, not to truly exempt employees such as store managers who qualify as executive or administrative employees. The *Ralph's* court thus distinguished between exempt managers and non-exempt employees for purposes of determining permissible bonus calculations.

Exempt Employees

The *Ralph's* court held that employers lawfully may calculate bonuses for exempt managers using a formula that includes deductions for any expenses and losses due to either cash or merchandise shortages. The court reasoned that such a profit-based bonus plan appropriately encourages exempt employees to manage their business enterprises to increase revenue while minimizing expenses and losses. The court noted that exempt managers, unlike non-exempt employees, have the ability to control business operations that directly affect revenue and expenses. Therefore, the court concluded, there is nothing unfair in basing bonuses on a formula that rewards managers for effective supervision.

Non-Exempt Employees

With regard to non-exempt employees, the court held that Ralph's could not require its non-exempt employees to bear the costs of management by effectively reducing an employee's bonus on the basis of expenses and losses resulting from cash or merchandise shortages not caused by the employee's own misconduct or gross negligence. In so holding, the court followed the California Supreme Court's reasoning in *Kerr's Catering Serv. v. Department of Indus. Relations*, 57 Cal. 2d 319 (1962). In *Kerr's*, the court, reasoning that "some cash shortages, breakage and loss of equipment are inevitable in almost any business operation," held that employers, rather than their non-exempt employees, must "bear such losses as expenses of management."

The distinction that the *Ralph's* court makes between exempt and non-exempt employees for purposes of including cash and merchandise shortages in calculating bonuses will be cause for caution for some employers who pay bonuses to managers on that basis. Under the *Ralph's* ruling, any mistake that an employer makes in classifying a non-exempt manager as exempt will result not only in liability for overtime premium pay and related penalties but also in additional penalties for failing to pay wages.

An additional cause for caution is the possibility that deductions for cash shortages and merchandise shortages are forbidden not only by the wage orders (as to non-exempt employees), but by Labor Code section 221, as to both exempt and non-exempt employees. The *Ralph's* court assumed that the prohibition on deductions in section 221 applied only to employees who are not part of "management," but that assumption may well be challenged by plaintiffs in future cases, and as of yet there is no definitive guidance from the California Supreme Court.

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