

CLIENT ALERTS

EPSTEIN BECKER & GREEN, P.C.

Resurgens Plaza
945 East Paces Ferry Road
Suite 2700
Atlanta, Georgia 30326-1380
404.923.9000

150 North Michigan Avenue
35th Floor
Chicago, Illinois 60601-7553
312.499.1400

Lincoln Plaza
500 N. Akard Street
Suite 2700
Dallas, Texas 75201-3306
214.397.4300

Wells Fargo Plaza
1000 Louisiana
Suite 5400
Houston, Texas 77002-5013
713.750.3100

1875 Century Park East
Suite 500
Los Angeles, California 90067-2506
310.556.8861

Wachovia Financial Center
200 South Biscayne Boulevard
Suite 2100
Miami, Florida 33131
305.982.1520

Two Gateway Center
12th Floor
Newark, New Jersey 07102-5003
973.642.1900

250 Park Avenue
New York, New York 10177-1211
212.351.4500

One California Street
26th Floor
San Francisco, California 94111-5427
415.398.3500

One Landmark Square
Suite 1800
Stamford, Connecticut 06901-2681
203.348.3737

1227 25th Street, N.W.
Suite 700
Washington, DC 20037-1175
202.861.0900

WWW.EBGLAW.COM

California Supreme Court Approves Incentive Pay Plans That Include Calculations for Workers' Compensation Costs

Court Issues Unexpected, Employer-friendly Decision

In *Prachasaisoradej v. Ralphs Grocery Company, Inc.*, No. S128576, the California Supreme Court granted an unexpected victory to employers who do business in the state and who wish to incentivize and reward their employees through bonuses based on net profits. In a lawsuit brought by a former employee of Ralphs supermarkets, the Supreme Court, in a 4-3 decision, reversed a Court of Appeal ruling and held that Ralphs' bonus plan, which was based on store profits and included a calculation for workers' compensation costs, did not violate a California law that prevents employers from shifting workers' compensation costs to employees. The Court determined that the bonus plan was in addition to the employee's ordinary wages and that the employees understood the terms of the plan. The decision has surprised many in the legal community and suggests that more employers in California will now implement bonus plans based on net profits.

Case Overview

In *Prachasaisoradej*, the California Supreme Court reviewed Ralphs' incentive compensation plan, under which certain employees of each store were eligible to receive, over and above their regular wages, supplementary sums based upon their store's profits. Under the plan, profits were determined by subtracting store operating expenses from store revenues. Significantly, one feature of the plan was that workers' compensation costs were deducted as part of store operating expenses. Previously, in *Ralphs Grocery Co. v. Superior Court*, 112 Cal.App.4th 1090 (2003), a Court of Appeal had reviewed this same plan and found it unlawful. In that prior case, the Court of Appeal found that the deduction of workers compensation costs was contrary to California Labor Code Section 3751 (a), which prohibits an employer from, among other things, "tak[ing] any deduction from [employee] earnings... , either directly or indirectly, to cover the whole or any part the cost of [workers'] compensation."

The Court of Appeal in the previous case had opined that the Plan effectively charged back a portion of such costs to employees through deductions from their wages. Disapproving both this prior Court of Appeal

CLIENT ALERTS

decision and the lower courts in the case at issue, a closely divided California Supreme Court in *Prachasaisoradej* found that the Plan did not violate California wage-protection laws because Ralphs was simply providing "supplementary compensation designed to reward employees, over and above their regular wages, if and when their collective efforts produced a positive financial result for the store where they worked." The Court found that, among the most significant aspects of the plan, it did not "create an expectation or entitlement in a specified wage, then take deductions or contributions from that wage to reimburse Ralphs for its business costs."

As the Court summarized, "[a]t the outset, all Plan participants received, regardless of the store's performance, their guaranteed normal rate of pay—the dollar wage they were promised and expected as compensation for carrying out their individual jobs." Plan payments were "over and above this regular wage" and plan participants "understood that their payments, and the amounts thereof, arose only under a formula that compared the store's actual Plan-defined profit, if any, for a specified period, with target figures previously set by the company." Finally, once the amount of an employee's plan compensation was calculated under this formula, Ralphs did not thereafter reduce it by taking unauthorized deductions, contributions, or charges. The Court did not find the deduction of workers' compensation costs as part of the plan particularly troubling. It deemed workers compensation costs "ordinary business expenses" that could be figured in along with such other store expenses as "the electric bill and the cost of goods sold" to determine the store's profit upon which supplementary plan payments were calculated.

In reaching its decision, the Court emphasized that "each employee was offered, promised, and paid full compensation for his or her individual work, an agreed and guaranteed dollar wage, which did not waver with the store's financial fortunes, and from which no unauthorized amounts were deducted, withheld, set off, or otherwise received or collected back by the employer." It further emphasized that the plan encouraged employees' cooperative and collective contributions to the profitable performance of their stores "by sharing with these employees, in addition to their regular wages, a portion of the profits, if any, their efforts had produced, and which Ralphs would otherwise be entitled to retain for itself." Central to the lawfulness of the plan was the fact that "it was only after the store had completed the relevant period of operation, and the resulting profit or loss figure was then derived, that it was possible to determine, by a further comparison to the preset targets, whether Plan participants were entitled to a supplementary incentive compensation payment, and if so, how much."

Implications for Employers

In a summer during which the California Supreme Court unanimously held in *Murphy v. Kenneth Cole* that premiums for missed meal and rest breaks are to be considered "wages" rather than "penalties," subjecting employers to a longer limitations period and additional penalties for alleged violations, the employer-friendly decision in *Prachasaisoradej* is an unexpected one. However, it is important that employers not misread the Court's decision. The Court concluded that Ralphs' well-drafted bonus plan did not violate the law. It did not hold that employers may take workers compensation into account in setting an employee's regular compensation, nor did it hold that all bonus plans that include a calculation for workers' compensation costs would necessarily be lawful. To the extent that employers wish to implement bonus plans that include such calculations, they must be careful to do so in a manner that complies with *Prachasaisoradej*.

At least two critical considerations should be kept in mind in light of *Prachasaisoradej*. First, if an em-

CLIENT ALERTS

-ployer decides to create an employee incentive payment plan that includes a calculation for workers' compensation costs, *Prachasaisoradej* suggests that it should be carefully and clearly structured to provide "supplemental" payments over and above the employees' ordinary wages.

Second, if an incentive plan will include the deduction of employer operational costs as part of the ongoing calculations of payments, *Prachasaisoradej* suggests those calculations are best made on a collective basis, rather than an individualized basis.

* * *

If you have any questions regarding the California Supreme Court's decision in *Prachasaisoradej v. Ralphs Grocery Company, Inc.*, please contact **Michael Kun** at (310) 557-9501 or mkun@ebglaw.com, or **James Michalski** at (310) 557-9534, jmichalski@ebglaw.com

This document has been provided for informational purposes only and is not intended and should not be construed to constitute legal advice. Please consult your attorney in connection with any specific questions or issues that may impose additional obligations on you and your company under any applicable local, state or federal laws.

© 2007 Epstein Becker & Green, P.C.

