

IS YOUR EMPLOYEE INCENTIVE PLAN LEGAL?

Employers are prohibited by law from receiving “rebates” of employee wages (i.e. to collect or receive from an employee any part of wages paid by the employer to the employee) under California Labor Code Section 221. Employers are also prohibited under the Industrial Welfare Commission Wage orders, from deducting employee wages or requiring reimbursement from an employee for cash shortages, breakage, or loss of equipment **unless it can be shown that these things were the direct result of dishonest or willful misconduct, or gross negligence on the part of the employee.** Along the same vein, **taking any deduction, or receiving any contribution from an employee’s earnings, either directly, or indirectly, to cover any portion of the employer’s workers’ compensation costs is also prohibited by law under Section 3751 of the California Labor Code.**

While most employers are aware of these regulations, what is less commonly known is that in recent years, the California Courts’ interpretation of these laws has made employers extremely vulnerable to litigation brought by employees who claim that their employers’ incentive plans are in violation of these laws. In *Ralphs Grocery Co. v. Superior Court* (October, 2003), the Court found that Ralphs’ incentive compensation plan violated the Labor Code because the calculation of employee bonuses under the plan was based on a formula that considered the stores’ profits and certain losses, including cash and merchandise shortages, shrinkage, and worker’s compensation costs.

While there may not be a “bulletproof” approach to implementing or modifying an existing employee incentive plan, below are some things employers may wish to consider:

Bonuses Based on Sales or Revenue

A bonus that is not reduced by any cost factor is, of course, ideal and bonuses that award employees for meeting specified sales targets should be acceptable. However, **deductions from sales numbers for unidentified merchandise returns or inventory shortages have been found by the Courts to be in violation of the Labor Code** (*Hudgins v. Neiman Marcus Group, Inc.*; 1995).

Bonuses Based on Behavioral Criteria Set by Management

Avoid bonus programs that “punish” management for unusual or protracted costs. For example, **a bonus that rewards managers for low incidence of accidents or workers’ compensation claims may be risky.** Instead, provide a bonus for behavioral metrics or observations on a manager’s actual job performance.

Profit Sharing Plans

Profit sharing **plans constructed under the Employee Retirement Income Security Act (ERISA) are not likely “targets”** within the context of this article, as ERISA does not restrict how profits are calculated, except that an amount accrued under a profit sharing plan must be determined by a “definite predetermined formula.” (26 U.S.C. § 401(a)(27)). However, **non-ERISA plans** that attempt to “share” profit by assigning bonuses based on the profit of the company, or a portion of the company (i.e. **with line items related to workers’ compensation costs, etc.**) may be at risk.

Discretionary Bonuses

Avoid creating a bonus plan in which payments are specifically stated and determinable at the beginning of the bonus period. Instead, issue bonuses upon the sole discretion of management, at the end of a bonus period. A true “discretionary bonus” that is not paid pursuant to any prior contract, agreement or promise, has no specific criteria and is therefore, less likely to create a problem in this context.

The “Line Item” Approach

Employers should implement or modify their existing bonus plans to exclude line item deductions for such things as: breakage, theft or shrinkage; third-party tort claims; employee overtime costs; casualty losses; cash shortages and most importantly, worker’s compensation costs (this list should not be regarded as exclusive). It is also advisable to avoid bonus plans which reward employees for any statistical measure of success related to workplace injuries. As stated previously, consider instead, granting bonuses to employees who meet specified metrics for safety compliance (e.g. scores on safety audits, etc.).

If you have any questions about this article or would like some assistance with the development or review and modification of an employee incentive plan, please contact this office.