GRUBE BROWN & GEIDT LLP

SAN FRANCISCO
601 Montgomery Street, Suite 1150
San Francisco, CA 94111
tel: 415.603.5000 | fax: 415.840.7210

LOS ANGELES
633 West 5th Street, Suite 3330
Los Angeles, CA 90071
tel: 213.358.2810 | fax: 213.995.6382

CALIFORNIA SUPREME COURT ADOPTS EMPLOYEE-FRIENDLY METHOD OF PAYING OVERTIME ON BONUSES

March 19, 2018

By Tom Geidt

In a very important and troubling decision for California employers, the state Supreme Court has set down new rules on how employers must calculate overtime for certain bonuses and incentives paid to non-exempt employees. In *Alvarado v. Dart Container Corporation of California,* the Court ruled that when an employer pays a bonus in a flat dollar amount – as distinct from, for example, production bonuses, commissions or piece rates, which tend to increase as employees work more hours – it must use a special formula for computing the "regular rate of pay" on that bonus. Specifically, the employer must divide the bonus by the number of *nonovertime* hours the employee worked during the relevant period, not the *total* hours worked, and multiply the resulting sum by 1.5 times the number of overtime hours worked (or 2.0 for double time) rather than 0.5 or 1.0. This method of paying overtime on "flat sum bonuses" will lead to more overtime pay for employees and a more complicated system of payroll administration for employers.

Moreover, despite the absence of any prior authority on this issue in any statute, regulation, or published court decision, the Court held that its ruling is to be applied retroactively, thus exposing California employers to potential backpay and penalty liability for past years if they have been using the wrong overtime calculation.

Dart Container's Attendance Bonus and Overtime Calculation

Dart Container Corporation, a manufacturer of food service products, paid certain of its employees an "attendance bonus" of $15 for each Saturday or Sunday in which they completed their scheduled shift. For example, if an employee was scheduled to work eight hours on a Saturday and did work at least eight hours on the Saturday, it paid the employee $15 for that week (or pay period) in addition to his hourly pay.

Dart Container also included these attendance bonuses in employees' overtime pay, using a calculation method permitted under the Fair Labor Standards Act ("FLSA"). Essentially, it added the bonus to the employee's other straight-time pay for the workweek and divided this sum by the total hours worked in the week (including overtime hours) to produce the "regular rate." It then multiplied the regular rate by the number of overtime hours worked in the week and divided this sum in half to determine the amount of overtime premium due for the week.

To illustrate, focusing on the bonus component only, if an employee worked 45 hours in a week (including five overtime hours) and received an attendance bonus of $15, the regular rate on the bonus portion of the paycheck would be calculated as $0.33 per hour ($15/45 hours), and the overtime premium paid on the bonus would be $0.83 (($.33 x 5)/2).

Plaintiff's Claim

A Dart Container employee, Alvarado, filed a class and PAGA representative complaint against the Company, alleging that it was using the wrong overtime calculation method for the attendance bonus. He argued that California law requires a different calculation for "flat sum" bonuses than for production bonuses and other variable incentives that tend to increase as more hours are worked. Alvarado maintained that employers should be using the same calculation for flat sum bonuses as they are required to use for salaries paid to salaried non-exempt employees – namely, dividing the bonus by no more than 40 hours rather than the total hours worked in the week, and then paying this "bonus regular rate" at 1.5 times the number of overtime hours rather than 0.5. (Section 515(d) requires this method for paying overtime on non-exempt *salaries* but not for any other form of pay.) Alvarado also noted that the California Division of Labor Standards Enforcement ("DLSE") has long favored this calculation method for flat sum bonuses in its informal enforcement policy.

Under Alvarado's method, the bonus regular rate in the previous hypothetical would be $0.375 per hour ($15/40 hours), and the overtime premium due on the bonus would be $2.81 ($.375 x 5 hours x 1.5). This is more than three times greater than the amount due under the FLSA method because of the different divisor (40 instead of 45) and the different multiplier (1.5 rather than 0.5).

The DLSE's Enforcement Position

Until now, no published California appellate court decision has ever held that employers must use Alvarado's proposed calculation method when paying overtime on a bonus. For many years, however, the DLSE has included a section in its Enforcement Manual asserting that employers who pay a flat sum bonus – for example, $300 for continuing to work through the end of the season or $5.00 for each day worked – should use a special calculation method that effectively allocates the bonus only to the nonovertime hours worked in the bonus period. According to the DLSE Manual, employers should divide the bonus amount by the maximum nonovertime hours to avoid deflating the regular rate, and then pay overtime at 1.5 times this rate rather than 0.5. *See* 2002 DLSE Enforcement Policies and Interpretations Manual §§ 49.2.4.2. *et seq.*

More than 20 years ago, the California Supreme Court ruled in a case known as "*Tidewater*" that DLSE Manual provisions such as this are "void underground regulations" entitled to *no* deference from the courts. This is because these DLSE Manual provisions were not promulgated in accordance with the Administrative Procedure Act. Dart Container argued, therefore, that the Supreme Court should not place any reliance on the DLSE's enforcement position.

The Supreme Court's Ruling

Both the trial court and the California Court of Appeal held that Dart Container's overtime calculation was lawful. The Supreme Court, however, adopted the DLSE's interpretation and ruled in favor of Alvarado. Although acknowledging that the DLSE interpretation was embodied in a "void underground regulation," the Court pointed out that this does not mean the DLSE's interpretation was necessarily wrong. Noting the agency's expertise and special competence, the Court was persuaded, after doing its own independent analysis, that the DLSE's policy correctly reflects California overtime law.

In reaching this ruling, the Court relied in particular on two California public policies. First, California public policy favors an eight-hour workday and a 40-hour workweek, and it discourages employers from imposing work in excess of these limits. Second, public policy dictates that the state's labor laws are to be liberally construed in favor of worker protections. According to the Court, both policies supported its ruling. The FLSA method used by Dart Container, in the Court's view, would encourage rather than discourage the imposition of overtime work, because it causes the regular rate to diminish as more hours are worked.

For part-time employees, the Court held that employers should calculate overtime using, as a divisor, the "nonovertime hours actually worked" in a week or bonus period, rather than 40 hours (the maximum nonovertime hours that can be worked in a week). Thus, for example, if an employee works three 8-hour days and one 10-hour day in the week (a total of 34 hours) and receives a flat sum bonus attributable to that week, the employer presumably would divide the bonus by 32 hours (not 34 or 40 hours) to determine the regular rate, then multiply this bonus regular rate by 1.5 for the two daily overtime hours. This part of the Court's ruling, too, is favorable to employees, as it will produce a higher regular rate than the one for full-time employees (because the lower the divisor, the higher will be the regular rate).

Notably, the Court limited its holding in *Alvarado* to flat sum bonuses, not to production bonuses, piecework pay, or commissions, where supplemental pay tends to increase in rough proportion to the number of hours worked, including overtime hours. Ominously, however, the Court did not expressly endorse the FLSA method for these other forms of supplemental pay; it merely observed that a different method than the flat sum method "may be warranted" for such forms of pay.

Retroactive Effect of the Ruling

Dart Container and interested employer organizations argued to the Court that, as a matter of fairness and due process, its decision should be applied only prospectively, not retroactively, because employers could not reasonably have known they must use the flat sum method in the absence of prior court or (valid) administrative guidance. Unfortunately, the Court rejected this argument. According to the Court, the DLSE's enforcement position, even though invalidly promulgated, was sufficient to put California employers on notice of the possibility that this calculation method is the one they should be using. The Court also concluded that prospective application would unfairly allow employers to escape the penalties and remedies due and owing to affected employees.

In a concurring opinion, four of the justices lamented the fact that the DLSE had not issued a formal regulation on this issue in the past decades, as this would have provided a "more robust basis for employers and employees to structure their affairs." "Regrettably," the concurring justices wrote, "more was not done to help employers meet their statutory responsibilities, or to ensure that employees receive the overtime pay they were due."

Conclusion and Recommendations

It is long been well-established under the FLSA and California law that employers must pay overtime on most bonuses and other incentive payments to non-exempt employees, unless the bonuses are purely discretionary or fall within one of the enumerated statutory exceptions for certain overtime premiums. California law has always been muddled, however, on the issues of: (1) exactly which of the many categories of employee remuneration must be included in the regular rate and which may be excluded; (2) how overtime must be calculated and paid on the various includable bonuses and incentives; and (3) how the base pay and overtime pay relating to such bonuses must be shown on California pay stubs. Each of these questions involves complicated and technical issues.

Regrettably, the Court's decision in *Alvarado* will complicate the process further for employers in California and their payroll departments. Complying with the new requirements will present a significant burden and cost.

Also, unfortunately, this decision is sure to generate much new litigation, especially because of the Court's troubling decision to apply its ruling retroactively. The monetary amounts by which most employees have been underpaid through use of the FLSA bonus calculation method rather than the "flat sum" method generally will be quite small when calculated on a per-employee basis. Plaintiffs' lawsuits, however, undoubtedly will seek the full panoply of penalties and remedies on behalf of entire workforces spanning several years, all of which in the aggregate could lead to significant potential exposure. "Regular rate" lawsuits already have been on the rise. This will only worsen California's already-overheated litigation environment in the wage and hour arena.

As a result of the *Alvarado* decision, it is imperative that employers in California promptly reexamine their bonus programs and other pay categories, decide whether to modify or discontinue any of the bonuses they currently maintain going forward, review their overtime calculation methods, and make any changes necessitated by the Court's decision.

* * * * *

If you have any questions about this case or how it may affect your incentive programs, please contact any of GBG's attorneys.

Tom Geidt
Telephone: 415.603.5003
Email: tomgeidt@gbgllp.com