

MACFARLANES

BONUS SEASON - 10 THINGS TO THINK ABOUT

Many firms will be preparing for their annual bonus announcements. The sums involved and the risk to employee relations if you get it wrong make this a critical period for HR, reward and internal legal teams. In this note we offer 10 essential rules to help this year's bonus season to be as conflict-free as possible.

- 1. Absolute discretion is rarely absolute.** The courts have repeatedly stressed that contractual bonus clauses which purport to give an employer absolute discretion over whether to award a bonus at all, and the amount of any bonus awarded, seldom means what it says. Employers retain a wide margin of discretion, but decisions are almost always limited:
 - Rationality and perversity: Bonus decisions should be explainable, and based on sensible and logical judgments. Unjustifiable or demonstrably inconsistent awards risk being challenged on the basis they are perverse or irrational, both of which would permit the courts to intervene.
 - Reasonableness: The Supreme Court ruled last year (in *Braganza v BP Shipping Ltd* [2015] UKSC 17) that employers can sometimes be subject to a duty to act reasonably, in the sense that they should follow a fair process before taking any decisions, and should ensure all relevant factors are taken into account, while all irrelevant factors are excluded. These principles come from public law, governing the way governments and local authorities behave, and had the potential to widen the scope for Court intervention in discretionary awards. However, the competing sets of rules were analysed in a bonus case just before Christmas (*Paturel v DB Services (UK) Ltd* [2015] EWHC 3659 (QB)), with the judge finding a substantial overlap between public law unreasonableness and the limitations of irrationality, perversity and capriciousness that have traditionally controlled bonus discretions.
 - Trust and confidence: All employment contracts carry with them an implied obligation not to act in a way that is calculated and likely to destroy or seriously damage the relationship of trust and confidence. That obligation mirrors the reasonableness and irrationality constraints we've already touched on, and usually includes a duty to give reasons.
- 2. Contractual drafting matters.** Understanding the precise drafting of each bonus clause or scheme is critical to avoiding conflict. Many clauses require particular factors to be taken into account, such as individual or business unit performance. Failure to operate the contractual provisions properly will open any decision to challenge. Equally, we sometimes come across clauses which use ambiguous language - this should be avoided wherever possible. Using words like "exceptional" as a trigger for bonus awards, or adopting unclear definitions of performance, are often capable of competing interpretations, which inevitably increases the risk of litigation.
- 3. Beware oral promises.** Managers can be tempted to pacify their direct reports by making positive noises about their forthcoming bonuses. This can be extremely dangerous, as those positive noises can very easily become contractual promises or bolster an argument that trust and confidence has been undermined. Executives and line managers should be reminded to be cautious in their use of language in the period before bonuses are announced.
- 4. Terminating just before bonus award date is risky.** Many bonus schemes state that no bonus is payable if the employee is under notice, or has been terminated, before the bonus award date or payment date. It can therefore be tempting to dismiss an under-performing employee or place them on notice to avoid having to bother including them in the bonus round. If the aim is essentially to deprive the employee of a benefit, and there is no genuine and fair reason for dismissal, such a step carries a high risk of challenge.
- 5. You can usually link bonus awards to the signing of new contracts.** Many employers use the carrot of a bonus to incentivise employees to enter into new contracts of employment, perhaps with more restrictive post-termination covenants. This is usually achievable from an employment law perspective, although care should be taken over the process followed.
- 6. Employees on family leave need to be treated fairly.** Depending on the precise wording of the scheme, it is usually permissible to pro rate a performance-related bonus to reflect any period of family leave (except compulsory maternity leave). Company-wide bonuses, particularly those intended to reward loyal service, are more complex, and advice should always be sought if you are contemplating withholding such a bonus from those on family leave.

7. **PLCs must have regard to their directors remuneration policy.** The UK Corporate Governance Code and the Companies Act 2006 both contain important restrictions on how listed companies can deal with executive bonuses. The essential points are that all remuneration must be consistent with the company's remuneration policy unless the shareholders approve otherwise, and remuneration committees should ensure bonus decisions strike the right balance between individual reward, risk, and the long-term health of the company, using stretching performance conditions, deferred vesting periods, cash and non-cash elements as appropriate.
8. **FCA-regulated firms must have regard to the Remuneration Code.** The detail of the various FCA and PRA remuneration codes is beyond the scope of this eBulletin, but the key watchwords are that a portion of any bonus award must be deferred, a portion must be non-cash, there must be scope to retroactively adjust any award to take account of subsequent events (such as a material financial downturn or the discovery of misconduct), and bonuses are subject to an overall cap so that the ratio of fixed to variable remuneration is 1:1, or 1:2 with shareholder approval.
9. **Record-keeping matters.** We've touched on the importance of well-reasoned and logical decision-making in reducing the risk of claims for breach of contract or discrimination. Proper record-keeping is just as important, as it is relatively easy to be able to obtain all internal material relating to a particular bonus decision either by the disclosure process if the claim goes to litigation, or by way of a subject access request under the Data Protection Act. Firms should therefore ensure internal discussions are consistent with the eventual outcome, and that managers are reminded not to indulge in careless banter, particularly over email, text, or other messaging system.
10. **Clawback provisions are usually enforceable.** It is now increasingly common to see bonus provisions requiring the repayment of part or all of a bonus in particular circumstances. This sort of provision is mandatory in the FCA-regulated sector, as we have noted, and is growing in popularity in other industries. The key point is that a clawback provision needs to be carefully drafted. Poor quality wording can allow employees to argue clawback operates as an unlawful restraint of trade, or an unenforceable penalty or forfeiture provision.

If you'd like to discuss your own bonus deliberations, or have any other employment law issues, please don't hesitate to contact us.

CONTACT DETAILS

If you would like further information or specific advice please contact:

HAYLEY ROBINSON

PARTNER
EMPLOYMENT
DD +44 (0)20 7849 2969
hayley.robinson@macfarlanes.com

MATTHEW RAMSEY

PROFESSIONAL SUPPORT LAWYER
EMPLOYMENT
DD +44 (0)20 7849 2549
matthew.ramsey@macfarlanes.com

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MACFARLANES LLP

20 CURSITOR STREET LONDON EC4A 1LT

T +44 (0)20 7831 9222 F +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com

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