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BRIEFING

Exercising discretion in bonus schemes

Employment, pensions and benefits – contentious issues: briefing 15

Executive summary

Employers have two main issues to consider when making bonus decisions. They must decide whether individual employees are entitled to a bonus at all and then determine the level of the bonus that is to be paid. Failing to address these issues correctly can result in costly breach of contract and discrimination claims. This briefing suggests how the bonus process should be operated to try and avoid such claims.

Recent cases show the cost of getting bonus decisions wrong: record sums have been awarded as damages for breach of contract or compensation for sex discrimination. Suggestions on how employers can protect themselves against such claims are outlined below.

Avoiding contractual claims

Two questions should be asked at the outset: whether the employee is entitled to participate in a bonus scheme, and how to determine the amount of any bonus. The terms of the scheme and recent cases limiting an employer's freedom to determine bonus levels affect these issues.

- Is there any entitlement to be considered for a bonus? In most cases it is clear whether an employee is entitled to be considered for a payment. However, where a bonus scheme is said to be 'discretionary' there may be an argument that it is entirely at the employer's discretion whether to pay bonuses at all. If an employer wants to rely on such an argument, it must review the bonus terms carefully. Saying that a bonus scheme is discretionary does not mean that it can be withdrawn or changed at will unless the clause is properly drafted. For example, in *Chequepoint (UK) Ltd v Radwan* a scheme was expressed to be 'at (the Company's) absolute discretion... the terms and conditions to be notified to employees from time to time'. The Court of Appeal found that once the terms had been issued, they could only be changed or withdrawn with notice. Otherwise the employees were entitled to a bonus on the existing terms.

- If an employee is entitled to be considered for a bonus, but the amount to be paid is discretionary, can the employer opt to pay no bonus? This will depend on whether there are good reasons for the employer's decision. In *Clark v Nomura*, the High Court found that even where an employer has a discretion on the level of bonus, it is not an absolute discretion. An irrational or perverse exercise of discretion will be a breach of contract. The key question is whether a reasonable employer would have acted in that way. If there are sound reasons for reaching a particular decision, it is unlikely to be irrational or perverse. In practice it will be more difficult to challenge a low award than no award at all.
- The terms of the scheme will also need to be reviewed to check for any other limits on the exercise of discretion. In *Clark* the bonus payment was 'not guaranteed in any way and dependent upon individual performance'. The only proper factor for the employer to take into account when determining the level of bonus was the individual's performance. Other factors (such as the fact that the employee was about to be dismissed) were irrelevant and had to be disregarded when determining the level of bonus to be paid.

Avoiding discrimination claims

The exercise of a discretion on bonus levels can also give rise to discrimination and equal pay claims. Some practical steps employers can take to minimise the risk of such claims are discussed below.

- If the scheme does not specify how bonuses will be calculated, an employer should start by considering the factors it will take into account when deciding bonus levels. As far as possible, these factors should be objective – for example by linking bonuses to set performance targets. In the past, employers have not wanted to fetter their discretion by openly stating what factors are relevant to bonus decisions. However, it will be easier to demonstrate a non-discriminatory pay policy where the factors being used to reach a decision are defined. On balance, outlining the basis on which bonuses will be awarded is less risky than being unable to demonstrate the factors that have been taken into account.
 - Once the employer has determined the general factors to be applied, it must apply those factors to each eligible employee. A note should be kept of how each decision has been reached, to help the employer show that there is no discrimination in the decision making process. For example, one of the factors that led to the finding of discrimination in *Bower v Schroders Securities* was the employer's inability to explain why it had paid the applicant (a woman) a bonus of £50,000 when men in a similar position had received around £500,000. The tribunal inferred that the applicant's performance had been undervalued because of her gender.
 - Keeping careful notes showing that each factor has been applied to the employee objectively should help a company rebut a suggestion of discrimination – either to the employee to avoid a claim being brought at all, or subsequently at a tribunal hearing. Similar records should be kept if during the process any bonus is increased or reduced. Reflections on the employee's performance should be consistent. For example, if the individual has been given a favourable appraisal, a tribunal is likely to be sceptical about a bonus assessment indicating mediocre or poor performance.
 - Employees conducting the bonus process should have suitable equal opportunities training. This is particularly important where the factors being applied are subjective – for example an assessment of an employee's performance where there is no formal way to measure performance. Combined with an open process, this should help persuade a tribunal that decisions that have been taken are not tainted by discrimination.
 - Once bonuses have been paid, an employer should check that the system is not having unintended discriminatory effects. This involves comparing the bonuses received by men and women doing equal work. If the comparison reveals that one sex has typically received higher bonuses, the reasons for those variations need to be investigated further and, where necessary, corrective action taken. Even where discrepancies are not revealed, an employer might want to take the opportunity to review its bonus scheme and introduce more objective targets for the following year – eliminating the risk of discrimination further.
Conducting such a review might be seen as a double edged sword. Results of the review will be disclosable in tribunal proceedings or in response to an equal pay questionnaire. However, the employer can at least demonstrate that it takes its equal pay obligations seriously and take an informed decision about whether to settle claims at an early stage. It will also help to eliminate equal pay issues and the risk of claims in the future – which ignoring a problem obviously will not.
- These steps may seem onerous, but are likely to be increasingly important. In the most recent decision on bonuses, *Barton v Investec Henderson*, the Employment Appeal Tribunal (EAT) stressed the need for employers to operate a transparent pay structure – one that is clear and easy to understand. Adverse inferences could be drawn from a failure to operate such a structure. The EAT also confirmed that once an employee demonstrates facts from which discrimination could be inferred (such as differential bonus levels) the employer must prove that it has not discriminated. This suggests that tribunals will be unwilling to condone bonus arrangements that lack transparency and that persuading tribunals that such arrangements do not have discriminatory effects will be harder in the future.

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