

PRESS CUTTING

Personnel Today
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Bonuses: A ball of confusion

Bankers' bonuses have been a focus of media attention in recent times. Yet clipping and clawing back bonuses is fraught with legal difficulties, as Catriona Watt and Ronnie Fox explain.

Most politicians do not understand how the City works. They are arguing that because of the bonus culture, senior executives in the financial services sector take risks that pay off in the short-term without regard to the long-term negative consequences for their business and the economy generally.

They say that excessive risk-taking is encouraged because traders' own money is not at risk. Politicians are seeking to divert attention from their own shortcomings by blaming bankers for the current economic situation.

Also, the government is threatening broad-brush legislation to control bonuses to end the 'short-term bonus culture'. But does it have the power to do this and, if so, how will it work in practice?

Q What are the different kinds of bonuses that can be offered to employees and directors?

A The different kinds of bonuses on offer are:

- **Non-contractual and totally discretionary:** the employer has complete discretion as to when to pay and how much, if at all, to pay.
- **Non-contractual and partially discretionary:** the plan provides for maximum annual payments and sets out the performance measures and payment provisions.
- **Contractual, with discretionary terms:** the plan contains subjectively measured performance targets.
- **Contractual, with contractual terms:** the plan contains the performance target and payment terms, and these are objectively drafted.

Q How distinct are these differences?

A In practice, the boundaries between these distinct categories are less than clear. Courts have become increasingly willing to find that bonus arrangements expressed to be non-contractual or discretionary can give rise to legally enforceable contractual or quasi-contractual rights.

Q What right does the government have to withhold bonuses from employees in banks in which it has a major stake?

A The government has recently announced a plan of action for banks in which it has a stake. Adherence to the plan will be one of the conditions to be accepted before the government pumps in more taxpayers' money to bail out insolvent banks.

The plan consists of various principles – namely, that banks should not reward those who fail or who are associated with a loss; that bank bonuses should be based on long-term sustainable performance; and that banks must have the right to claw back bonuses from their staff based on subsequent underperformance.

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Amending bonus schemes to effect these changes will not be straightforward. For employers with bonus schemes that have a truly discretionary element, that element can probably be amended within the scope of the discretion without employee consent as long as this is done before the employee becomes entitled to payment. Employers are carefully considering all the terms of their plans, employee communications about the plans, and the history of bonus payments before concluding that any element is discretionary.

If a bonus plan is fully contractual, then it will be essential to seek the consent of the participants to future changes. This should be done in writing, and in plenty of time for the change to take effect before participants become entitled to receive payment. Employers should be prepared for employees to refuse to consent. Many will be told that their only choice is between accepting changes or losing their job and suing for breach of contract.

Q What action might the government take?

A There have been threats that the government will take retrospective action to prevent the payment of contractually enforceable bonuses to those who work, or have worked, at banks which the taxpayer has supported. Also, the government has said that benefits received by the senior management of such banks should be repaid. This principle is said by Harriet Harman, leader of the House of Commons et al, to reflect a judgment of the "Court of Public Opinion". The implications are that respect for the rule of law has been abandoned by the Labour Party, and that fundamental principles of the Human Rights Act count for nothing.

Moves to legislate in Parliament or withhold bonuses in individual cases could result in High Court cases for breach of contract and Human Rights claims.

Q What can an affected employee do?

A Where an employee has a contractual right to a particular bonus, the situation is clear. The situation is not so certain for employees with discretionary bonuses. Case law has shown that an employer with discretion as to whether to award a bonus will be in breach of contract if "no reasonable employer would have exercised its discretion in that way". An employer cannot exercise its discretion in a "perverse or irrational" way. Inconsistent practice, for example, awarding a certain level of bonus to some employees but not to others, could lead to a claim that discretion has been exercised unfairly. An employer must be able to show that it undertakes a meaningful and rational analysis of an employee's entitlement.

To enforce the payment of a discretionary bonus, an employee would have to prove that the employer has withheld or reduced bonuses in a way which is "irrational". Even if a bank has lost money as a whole, if individual performance is good, and an employee's division has made money for the bank, it may well be "irrational" to withhold an employee's bonus.

Q Will the government's proposals to allow employers to 'claw back' some or all of an employee's bonus really work?

A The government has stated that one way of reducing the risk culture is to allow employers to 'claw back' a proportion of bonus as a way of linking risk to reward and punishing poor conduct. However, in practice, this will be complicated to implement. Employers will need to decide which element – ie, company, team or personal performance – is to be affected by the claw-back. If an employee has not personally done anything wrong, a claw-back can be hard to justify merely because the company as a whole has not done well.

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Q What is the Financial Services Authority (FSA) doing to try to control remuneration policies?

A The FSA has published a draft code of practice for the remuneration policies of FSA-regulated firms. The main principle running through the code is that "firms must ensure that their remuneration policies are consistent with effective risk management".

The code appears to suggest that an individual's serious failings in risk management should put their entire bonus at risk, even if financial performance is very good. At this stage, it is only binding on banks which take part in the government's Asset Protection Scheme, but will form part of the FSA handbook of rules and guidance by November 2009.

The code is likely to substantially increase the responsibilities of remuneration committees and non-executive directors. Who would wish to be in Lord Myners' position?

Q What is the best way to link bonuses to long-term business success?

A Many employers defer payment of part of an employee's bonus by crediting a long-term incentive plan (LTIP). Such schemes now often have claw-back arrangements which enable the employer to reduce or eliminate a bonus pool if the business makes large losses. This encourages employees to take a longer-term interest in the success of the business. Employees also lose their entitlement under the LTIP if they leave their employment before the right to payment vests. This encourages those who have performed well and accrued a right to a significant bonus to stay with the employer.

Q What will affected employees make of this?

A Selling the notion of remuneration through LTIPs to middle management and junior employees will be difficult in the current climate, especially if there is a link to their employer's share price. Many employees have already watched hard-earned bonuses evaporate as share prices crash. Lehman Brothers shares once worth \$30bn (£21bn) were held by employees when the administrators were called in.

If banks want to recruit and retain the best talent to help them survive in a difficult environment, they will have to be willing to pay in the right way. One way is to link bonus payments to continuing employment to incentivise loyalty.

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