Parker & Co

Employment Update

January 2007

Introduction

This quarter's update focuses on two important bonus cases that should be noted by all employers. The cases discuss the boundaries of employers' discretion in calculating and withholding bonuses, and on the enforceability of contractual clauses terminating bonus entitlement at the end of the employment.

We also deal with payments for sickness during the notice period, pension provision under the new age discrimination regime and the status of without prejudice discussions.

If you have any questions arising from the articles, please call or email us and we will be happy to discuss them with you. As ever, your comments are welcome.

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NEW GUIDANCE ON BONUS PAYMENTS

Bonus payments and their calculation can be contentious issues. They are particularly important in the financial sector, where they form the major part of employee remuneration. It is common for employers to include clauses in contracts of employment to regulate employees' rights to bonus payments and the amount of them, including provisions limiting the right to a bonus or its amount:

- if notice of termination has been served by either party or if the employment has terminated by the bonus payment date for various reasons; and
- to the exercise of the employer's discretion and/or individual/departmental/company performance factors.

Discretion must be exercised rationally, not arbitrarily

By way of background, recent years have seen a large number of City bonus cases being fought in the courts. One of the defining cases emphasised how employers are constrained when determining levels of employee remuneration, despite its level being stated to be discretionary.

In *Horkulak v Cantor Fitzgerald International*, 2005, the employee's contract entitled him to a discretionary bonus. The Court of Appeal held that the employer was not entitled to exercise its discretion in determining the bonus in an irrational or perverse manner.

So, despite many bonus clauses allowing the exercise of discretion, employers do not have a free hand; they must not act arbitrarily or in a way that no other reasonable employer would.

Recent cases involving major banks have provided important guidance on bonus clauses and employees' entitlement to payment (*Commerzbank AG v Keen* and *Takacs v Barclays*, both 2006). The cases are extremely useful for employers in knowing to what extent they can rely on express contractual rights, and the extent to which implied terms can override such express contractual clauses.

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New Guidance on Bonus Payments, continued from page 1►:

Bank's discretion to calculate bonus and contractual clauses challenged
In *Commerzbank*, the Court of Appeal heard that the contract of employment provided the employer with discretion on the decisions as to whether to award a bonus to the employee, the amount of any award and the timing and form of it. The drafting stated that the employee would not be entitled to a bonus if he was under notice or no longer employed at the bonus payment date.

The employee received bonuses of nearly €3m in each of the 2003 and 2004 bonus years. His line manager had recommended bonus pools of between 15% and 18% of profit in 2003, and 17.5% in 2004, but instead the employer had subsequently reduced the bonus pool to 10% of profit in both years. In 2005, the employee worked for five months of the bonus year until his employment terminated by reason of redundancy; he was not paid a bonus for 2005. He claimed that:

- the employer had underpaid the 2003 and 2004 bonuses, in breach of an implied term of contract, by exercising its discretion irrationally or perversely in not following the recommended level of bonus;
- the non-payment of the 2005 bonus was a further breach, being an arbitrary exercise of discretion; and
- the clause entitling the employer to withhold a bonus due to the employee no longer being employed was a breach of the Unfair Contract Terms Act 1977 ("UCTA"). Although UCTA only applies to those dealing with businesses as a "consumer" on a business' standard terms, previous case law has indicated that it could be applicable to the employment relationship.

Court of Appeal finds Commerzbank was not irrational in bonus calculation
The Court held that an employer should provide "an employee with an explanation of the reasons for the exercise of a discretion in respect of additional pay". However, it noted that the employee had a high burden to prove that no rational employer would exercise its discretion in the way that Commerzbank had. In relation to the 2003 and 2004 bonuses, the Court held that the employee could not show the "overwhelming case" that no rational City bank would have reduced the bonus pool to less than the level recommended by the line manager.

For the 2005 bonus, the Court found that the contract was clear; there was nothing unusual in a bonus payment being delayed until the following year or in it being withheld where the employment had terminated by the bonus payment date. The Court also rejected the UCTA arguments raised by the employee; the bonus was payable for work performed as an employee, and not in relation to dealings as a "consumer" as UCTA requires. Further, the Court held that a contract of employment was not to be seen as the employer's "standard terms of business"; the business in question was banking, not the employment.

Non-payment of bonuses on termination of employment
In the *Barclays* case, the employee was entitled to a minimum guaranteed bonus in 2003 and 2004, and an additional bonus in those years based on achieving sales credits targets. His contract provided that bonuses would not be payable if he was no longer employed or was working out a period of notice at the payment date. However, the contract qualified this, stating that he would be entitled to the "2003 and 2004 awards" if he was dismissed for a reason other than gross misconduct.

In 2003, the employee did not achieve the sales target (having only worked part of the year) and only received the guaranteed bonus payment. In 2004 the employee worked on a lengthy transaction under which he would have achieved the necessary credits. He was dismissed near the year-end, before the transaction completed (the employer subsequently decided not to go ahead with the deal) and before any bonus became payable.

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New Guidance on Bonus Payments, continued from page 2►:

Employee challenges non-payment of bonus on dismissal
The employee claimed that he was entitled to payment of both the guaranteed and additional bonus (regardless of whether or not he achieved the sales credits target) because he was dismissed for a reason other than gross misconduct. He also claimed that the employer had breached its implied duties by undermining his efforts to complete the transaction, by not completing it and by terminating his contract to avoid paying his bonus, and thus that the employer was in breach of contract.

The employer applied for the claim to be struck out as having no reasonable prospect of success. The current decision is therefore not on the merits of the claim, but on the High Court's consideration of whether it has reasonable prospects of success. It held that:

- the contract was clear and excluded the employee's right to the additional performance bonus on termination of employment where the sales target had not been met. The target had not been achieved, so that part of the claim would fail;

- the employee's arguments regarding the employer's breaches of its implied duties did have some chance of success. The Court found that it was arguable that the employer could have breached:

    1. an implied term of contract by undermining the employee's ability to achieve his targets;

    2. a potential implied obligation on it not to prevent the fulfilment of a condition upon which the contract of employment depended, and that the employer's decision not to proceed with the transaction could have been an effort to frustrate the employee's efforts to achieve his targets;

    3. a potential implied term of contract by dismissing the employee to avoid paying the bonus.

This case is likely to proceed to a full High Court hearing and it will be interesting to see whether the employee can establish the implied duties that he alleges the employer breached.

Practical Advice for Employers on Bonus Clauses and Discretion

Secretive and vastly inconsistent bonus calculations hold potentially high risks for employers. The exercise of discretion in calculating a bonus carries the risk of an employee bringing a breach of contract claim in relation to an individual payment, as well as equal pay and discrimination claims when that payment is compared to those paid to similar employees.

Employers should exercise discretion in a bona fide and rational manner (even where the contract does not contain a particular formula for calculating the bonus) and be prepared to justify why the discretion has been exercised in a certain way. For example, it appears from the *Commerzbank* case to be acceptable to reduce the size of a bonus pool (beyond a line manager's recommendations) as long as it is not irrational to do so.

Clauses that expressly allow an employer to withhold a bonus where an employee is under notice or is no longer employed at the payment date are generally enforceable, even where the employee has worked for part of the bonus year. However, a dismissal deliberately made to avoid paying a bonus may amount to a breach of an implied term of contract. Employers may also have implied duties not to act in an unreasonable manner that detrimentally affects an employee's ability to achieve a bonus.

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In Brief

Increase in Compensation Limits

From 1 February 2007, the maximum compensatory award for unfair dismissal increase to £60,600. A week's pay rises to £310, meaning the maximum basic award and statutory redundancy payment will increase to £9,300.

Increase in Holidays

The DTI has announced proposals for full-time employees' minimum annual leave entitlement to rise from 20 to 24 days on 1 October 2007, and to 28 days on 1 October 2008. Many employers will be unaffected by this as the 24/28 day minimum entitlement will include the eight statutory bank holidays that most employees already receive in addition to their holiday entitlement.

Review of Grievance and Disciplinary procedures

The DTI has announced an independent review of the statutory minimum disciplinary, dismissal and grievance procedures, introduced in October 2004. The review will consider the options to simplify and improve the dispute resolution procedures, following concerns regarding the compliance burdens imposed on employers and employees. Recommendations are expected later this year.

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Pay in Lieu of Notice and Sick Leave

In *Burlo v Langley*, the Court of Appeal has held that an employee claiming compensation for unfair dismissal was not entitled to be compensated on the basis of full pay in respect of her notice period when she had in fact been unfit to work.

Ms Burlo worked as a nanny until she was dismissed in March 2004. Prior to her dismissal, Ms Burlo had been unable to work between 5 March and 12 July 2004 following a car crash. This period of absence covered her eight week contractual notice entitlement. Ms Burlo was entitled under her contract to Statutory Sick Pay during sick leave.

Following her dismissal, Ms Burlo brought unfair and wrongful dismissal claims. She succeeded on both in the Tribunal. Ms Burlo was awarded compensation for her unfair dismissal, which did not relate to notice as she was separately awarded wrongful dismissal damages of eight week's notice pay. On appeal, the EAT upheld the employers' argument that the wrongful dismissal damages should have been based on SSP.

Ms Burlo took her claim to the Court of Appeal, arguing that the eight weeks' notice pay should be awarded as part of her unfair dismissal compensation. She relied on *Norton Tool Co Ltd v Tewson*, a case from the 1970s, which held that it is good industrial relations practice to pay full pay in lieu of notice to an employee who is dismissed without notice, even though that could result in a windfall if the employee secures alternative employment during what would have been their notice period. The EAT had held that this *Norton Tool* principle was no longer good law. The Court of Appeal ultimately left this issue undecided. Therefore, it appears to remain the case that an employee is entitled to a payment in lieu of notice, without credit for earnings during the notional notice period, in any assessment of unfair dismissal compensation.

However, the Court did hold that *Norton Tool* was not authority for a wider principle that other principles of good employment practice can be applied when assessing an unfair dismissal compensatory award if they would result in awarding more than the actual loss suffered. In the present case, had Ms Burlo not been dismissed she would have received SSP during her notice while she was unfit for work. Therefore, SSP was the correct measure of Ms Burlo's loss for unfair dismissal purposes.

Employers should, however, be aware that employees who are only entitled to statutory minimum notice of termination of employment must be paid their average hourly rate of remuneration if they are off sick for all or part of the statutory minimum notice period. This does not apply to employees who are entitled to more than statutory minimum notice.

In Brief

Disability and Reasonable Adjustments

In *NTL Group Limited v Difolgo*, the Court of Appeal has held that, in a redundancy situation, an employer is not obliged to make reasonable adjustments to an alternative role before an employee had applied for it.

In this case, Ms Difolgo was disabled and only able to work on a part-time basis. She was made redundant, but refused to apply for an alternative role unless it was first changed from full-time to part-time.

Ms Difolgo alleged that this amounted to a failure to make reasonable adjustments. The Court did not agree and held that the employer's duty did not arise unless and until Ms Difolgo had actually applied for the new role.

Without Prejudice Settlement Discussions

Since the decision in *BNP Paribas v Mezzotero* it has been clear that speaking to an employee "off-the-record" does not necessarily protect that conversation from disclosure in a Tribunal if there is no dispute between the parties or the communications are not a genuine attempt to compromise an existing dispute. The EAT, in *Brunel University v Vaseghi*, has now considered this topic again in the specific context of a victimisation claim.

In 2003, two employees made complaints of race discrimination against, the University. Twice, in March 2005, the University's Vice Chancellor commented on the claims in his newsletters, including an allegation that they had been "accompanied by unwarranted claims for money". The employees raised separate grievances alleging victimisation. Neither grievance was upheld.

Victimisation claims were then lodged with the Tribunal, with the employees seeking to adduce supporting evidence from a solicitor involved in the settlement negotiations. The University objected, arguing that the settlement discussions were "without prejudice" and not admissible in evidence. At first instance the Tribunal held that while the solicitor's evidence was without prejudice, the University had waived privilege in respect of the evidence heard during the grievance hearing and therefore the grievance panel's reports should be admitted as evidence.

On appeal, the EAT held that "in discrimination cases the necessity of getting to the truth of what occurred and if necessary eradicating the evil of discrimination may tip the scales as against the necessity of protecting the without prejudice privilege".

As a result of this decision, where discrimination or victimisation is or may be alleged by an employee, employers should not only exercise caution before engaging in any off-the-record discussion, but should also be wary as to the content of those discussions and their subsequent use in open forums, such as grievance hearings. This is in addition to considering the appropriateness of without prejudice discussions in the first place.

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In Brief

Validity of Compromise Agreements

Compromise agreements and the extent of claims waived by them have been the subject of a number of recent decisions. In *Palihakkara v BT Plc*, an employee signed a compromise agreement in settlement of "all claims past or future arising out of the termination of her employment".

The EAT held this wording was insufficient to compromise claims arising prior to termination. In addition, the agreement failed to compromise a race discrimination claim as it did not state that the conditions specified in the Race Relations Act 1976 (to achieve a valid waiver of claim) were satisfied. Therefore, Ms Palihakkara was free to pursue her race claim, regardless of the fact that the intent of the parties to compromise it was clearly recorded in the agreement.

This decision reinforces the importance of careful, technical drafting of compromise agreements to ensure statutory requirements are met and a valid waiver achieved. If you would like your standard agreement reviewed, please speak to your usual Parker & Co contact.

When Do Agency Workers Become Employees?

There has been a recent tendency for Tribunals to infer the existence of an employment relationship between an end-user and a worker supplied by an employment agency. This has created problems for employers who use temporary agency workers, as they have been at risk of long-serving agency workers claiming employee status. To employers' relief, the EAT has recently handed down clearer guidance on when such an implied contract exists (*James v Greenwich Council*, 2006).

Mrs James had carried out work for Greenwich Council through an agency for five years. Despite this, she argued that she was an employee of the Council by virtue of an implied contract and therefore had unfair dismissal rights. Mrs James acknowledged that there had initially been a genuine arrangement through an employment agency which supplied her services to the Council, but argued that the passage of time had superseded this and that she had become an employee of the Council. The Employment Tribunal held that no such implied contract existed. Mrs James appealed to the EAT.

The EAT rejected Mrs James' appeal making the following points:

- The passage of time alone is not sufficient to imply that a contract of employment exists, rather than an agency relationship.
- There must be sufficient mutuality of obligation. Where the end-user (Greenwich Council) is not able to insist that the agency supplies a particular worker (in this case, Mrs James) it is inappropriate to find that an implied contract of employment arose. Further, the Council was not responsible for Mrs James' remuneration or the provision of benefits such as sick pay. The monies paid to agencies by end-users often include elements such as expenses and commission and therefore the end-user may often be unaware of the amount of pay that the worker receives.
- Where arrangements with an agency are genuine and reflect the reality of the parties' relationships, there will rarely be evidence allowing the Tribunal to imply that a contract of employment exists. This is particularly so if there was no pre-existing relationship, as in this case, between the end-user and the worker prior to the establishment of a relationship via an employment agency.
- The EAT stated that for the existence of a contract of employment to be inferred there must be something, either words or conduct, which evidences a change in the arrangements so that the agency relationship no longer reflects the reality of the situation. It must be evident that the worker is working for an organisation because of mutual obligations binding both on the worker and the end-user.

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In Brief

Failure to follow statutory procedures

The EAT has confirmed that an employer's failure to follow the statutory dismissal or grievance procedure does not, in itself, provide employees with a free-standing Tribunal claim.

This is a common query from employers dismissing an employee with less than a year's service. However, if the minimum procedure is not followed, employers still risk a 10-50% compensatory uplift if the employee succeeds with a claim requiring no qualifying service, such as discrimination or whistle-blowing. Given that risk, it remains good practice to follow the minimum procedures for all employees, irrespective of their length of service.

Challenge to Age Discrimination Legislation

The challenge to the age discrimination regulations has been referred to the ECJ. The National Council on Ageing is arguing that by permitting forced retirement at 65, the Government has failed to adequately implement the EC Equal Treatment Framework Directive on which the UK legislation is based. Further updates will follow as the case progresses through the European judicial process.

Age Discrimination and Pension Provision

The Employment Equality (Age) Amendment No. 2 Regulations 2006, which deal with pensions, came into force on 1 December 2006, two months after the employment provisions came into effect. The pension aspects of the Regulations were postponed to give businesses time to adjust and to allow an informal consultation period, as a result of which further amendments have been made.

The Regulations make it unlawful for pension schemes and employers to discriminate against members or prospective members on the basis of age. However, they also recognise that pensions are inherently age-related. Accordingly, specific exemptions are included together with certain instances where age discrimination may be justified.

The most important employment-related exemptions and situations where discrimination may be justified are listed below:

- **Early retirement in a redundancy situation:** There is a specific exemption for the granting of early retirement benefits in a redundancy situation on age related grounds. Please note that the situation must be a genuine redundancy situation as defined by the Employment Rights Act 1996.

- **Ill-health retirement:** You can grant enhanced benefits for ill-health, early retirement with different minimum ages for this benefit applying to different groups or categories of employees.

- **Admission to a pension scheme:** You can set a minimum or maximum age for admission to schemes including different ages for different groups or categories of employees. Closing entry to a scheme to new members is allowed (which might otherwise be indirectly discriminatory for age related reasons).

- **Contribution rates:** You can impose a minimum level of pensionable pay for admission to a pension scheme (which otherwise might be indirectly discriminatory for age-related reasons).

  You can allow different contribution rates for employees on different rates of pay (which otherwise might be indirectly discriminatory for age related reasons).

  In money purchase schemes and personal pension schemes, age-related contributions can be made provided that the aim is to equalise or provide more equal pensions in respect of comparable pensionable service for members of different ages. Contributions can be given up to a maximum level of pensionable pay.

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WHAT'S COMING UP?

1 April 2007: new maternity and flexible working rights first take effect

6 April 2007: employers with between 100 and 149 employees become subject to the Information and Consultation Regulations (the regulations already apply to businesses with 150 employees or more)

1 October 2007: minimum holiday entitlement set to rise to 24 days per annum (including bank holidays).

1 October 2007: the Commission for Equality and Human Rights to be established

6 April 2008: employers with between 50 and 99 employees become subject to the Information and Consultation Regulations.

1 October 2008: minimum holiday entitlement set to rise from 24 to 28 days per annum (including bank holidays).

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- **Discriminatory action which may be justified:** Like other employment benefits, setting a length of service requirement is exempt provided that it is not longer than five years. If it is more than five years, the employer must provide the trustees of the pension scheme with a business justification.

  Discrimination may be justified if it is a "proportionate means of achieving illegitimate aim". This is not defined but guidance suggests that a defence of an objective justification will only succeed if the employer can show that the practice was adopted to pursue a legitimate aim such as reducing staff turnover, providing promotion opportunities or encouraging staff loyalty, the means adopted to achieve the aim were proportionate and it was necessary to achieve the aim.

  A measure will not be considered to be proportionate if a less discriminatory method to achieve the same result could have been used.

Those of you who have responsibility for pension provision should take specialist pension advice on your scheme and the impact of the Age Discrimination Regulations.

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