

BONUSES – THE PITFALLS

Introduction

For some time now, Hong Kong employers have been moving away from fixed guaranteed annual bonuses in favour of discretionary performance-based bonuses, particularly for senior, professional and managerial staff.

In some areas, such as the financial services industry where the remuneration of professional employees is “back-end loaded” (ie. their base salaries are a mere fraction of the amount they can expect to earn in bonus payments), this is obviously not a new development. However, a number of recent cases indicate that employees are increasingly prepared to litigate, and the courts prepared to examine, the payment of bonuses, even if the nature of the bonus is stated to be at the company’s discretion.

The intention of this article is to provide an overview of the legal principles involved in relation to assessment of bonuses and, in particular, discretionary bonuses. In order to do this, we examine:

- the nature of discretionary bonuses and how such bonuses differ from contractual bonuses,
- where the bonus is truly discretionary, we identify the main principles to be applied in the exercise of such discretion, and
- we discuss the application of these principles in three recent cases, one from the UK and two from Hong Kong.

What is a discretionary bonus?

A discretionary bonus can be distinguished from a contractual bonus (where failure to pay results in clear breach of contract).

A contractual bonus need not be a guaranteed amount. As long it can be assessed by reference to clear contractual targets (eg. as a percentage of profits, operating surplus etc), the employee will have a contractual entitlement to have his or her bonus assessed and paid in accordance with those targets.

The payment of contractual bonuses is also regulated by Part IIA of the Employment Ordinance which provides, among other things, that a pro-rata portion of such bonus must be paid to an employee dismissed part way through the bonus year (subject to the condition that the employee must have been employed for at least three months in the relevant bonus year). Therefore, where a Company has a contractual bonus scheme in place, it should be aware that employees who have been dismissed prior to the payment date of the bonus will still be entitled to a pro-rata payment of the bonus at the time it is assessed (unless, as a practical matter, the pro-rata payment can be calculated at the time of dismissal).

Turning now to the concept of a “discretionary” bonus.

“Discretionary” can mean either:-

- the entitlement to be considered for a bonus (e.g. "the Company may at its discretion, pay a bonus to its employees"), OR
- more commonly, that the amount of the bonus is discretionary (“you will be entitled to participate in our annual discretionary bonus scheme under which bonuses are determined by reference to your performance during the year”).

Pitfalls of Discretionary Bonuses

The two main pitfalls to be avoided are:

- exercising the discretion by reference to irrelevant parameters (ie. if contract states that payment of bonus is conditional upon "employee's personal performance" and, in exercising its discretion, the company also takes account of additional external factors such as the performance of the company as a whole, then this is an incorrect exercise of discretion), and
- exercising the discretion in a perverse, irrational or "capricious" manner such as to destroy the "implied duty of good faith" between employer and employee ie. that no reasonable employer would have exercised its discretion in this way.

Recent cases - Clark v Nomura International plc

The case of *Clark v. Nomura International plc* (6th September, 2000)¹ neatly illustrates both of these principles.

"Irrelevant parameters"

Mr Clark, a successful proprietary equities trader, was entitled to a bonus, payment of which was “dependent upon individual performance”. His annual salary was £100,000. In his first year of employment he earned Nomura profits of £13.5M for which he was paid a bonus payment of £2.5M. In his second year, he earned Nomura profits of £22M. Mr Clark was then dismissed on notice. During his period of notice (while on garden leave), Nomura exercised its "discretion" not to pay Mr Clark any bonus.

The Judge determined that the factors considered by Nomura in not paying Mr Clark’s bonus did not relate to “individual performance” (which the judge interpreted as meaning earning profits for Nomura, Mr Clark’s performance on this basis being exemplary), but rather involved additional irrelevant factors such as:-

- a perception that Mr Clark was unwilling to accept additional managerial responsibility,
- his boss did not like him, and

¹ [2000] IRLR 766.

- Mr Clark had been “difficult” over his termination and critical of certain practices of Nomura.

The Judge therefore concluded that Nomura had incorrectly exercised its discretion in respect of Mr Clark’s bonus. It should have simply considered individual performance.

"perverse, irrational"

In light of Mr Clark’s exemplary performance, the Judge determined that “No rational company would [in the given circumstances] award ... a nil bonus” and awarded a payment to Mr Clark of £1.35M.

Joanne Wood v. Jardine Fleming

The case of *Clark v Nomura* can be compared with the recent Hong Kong case of *Joanne Wood v. Jardine Fleming*.²

The relevant term in Ms Wood’s contract of employment was:

“the Company will at its discretion pay you an annual bonus each year in respect of your service with the Company during the previous year ending 31st December. The amount (if any) will depend on the financial result of the Jardine Fleming Group and on your own performance”.

Ms Wood was dismissed with effect from 4th November, 1997 and claimed a bonus payment for 1997.

Ms Wood’s claim was rejected by the Judge on the grounds that Jardine Fleming did consider her personal performance and, on justifiable evidence, found it to be below the standard necessary to justify a bonus (i.e. Jardine Fleming had exercised its discretion by reference to correct parameters and not in a capricious or irrational manner).

Vanessa Post v. Nomura International (Hong Kong) Ltd

The most recent case in this area is *Post v Nomura International (Hong Kong) Ltd*.³ This case involved a claim for payment of a contractual bonus and payment of a discretionary bonus.

The Judge found that there was no enforceable agreement regarding a contractual bonus.

In respect of the discretionary bonus, the relevant provision was contained in the Company’s Staff Handbook and provided that:

“The Company’s performance, together with your own performance and contribution will be used as a basis for determining eligibility for, and the amount of, any incentive bonus. The amount of any bonus payable shall be at the complete discretion of the Company ...”.

² HC unreported, Judge Woolley, 16th February, 2001.

³ HC unreported, Judge Kwan, 29th May, 2001.

Applying those parameters to Ms Post's claim, it was not in dispute that the Company's financial results for the relevant year were "significantly negative". Neither was Ms Post's contribution in dispute. However, the Company's position was that as a top employee, Ms Post was expected to achieve a top performance; there was no special or exceptional contribution on her part to merit a bonus award. In assessing the Company's exercise of discretion in respect of this parameter, the Judge was unable to say that the Company had acted in a perverse or irrational manner in not awarding a bonus to Ms Post.

In relation to Ms Post's performance, there was some dispute as to whether her team had made a profit or loss in the relevant year (which depended on whether indirect and marketing costs were included in the assessment). However, the Judge's view was that "so long as the costs sought to be included by the defendant were not perverse in that no reasonable employer would have exercised his discretion in that manner, the court should not substitute its views for the defendant's management as to what elements of cost should or should not be included." As stated by the Judge, "The question was not one of fairness to the plaintiff but whether the exercise of discretion was irrational".

Ms Post's claim was ultimately rejected by the Judge on the basis that as there was no profit generated by her team, it was not irrational or perverse for the defendant not to award a discretionary bonus to Ms Post. The Judge noted that Ms Post's case was very different from *Clark v. Nomura* where the profit generated by Mr Clark was not in dispute.

Conclusion

There are two important principles which can be gleaned from the recent cases discussed above and which a company should bear in mind in making provision for discretionary bonus payments.

First, the discretion in the contract of employment should be made as wide as possible (eg. "individual performance of the employee as well as the overall performance of the Company and such other factors as the Company may determine"). Ideally, the contract will not refer to specific performance targets which govern the assessment and payment of the bonus (and which are likely to render the bonus contractual in nature rather than discretionary).

Second, a company should exercise its discretion in a rational and not capricious manner. In particular, the company should ensure that any decision not to award a bonus is objectively justifiable (and, insofar as is possible, documented) by reference to the parameters set by the Company for the assessment of the bonus and not by reference to any irrelevant parameters.

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