

Treatment of Bonuses – Expect a Fight

Remuneration in the financial services industry continues to attract considerable press coverage. In addition to the inevitably contentious decision by an employer to withhold a bonus, there is also a wave of political, and consequently regulatory, pressure for financial services firms to implement arrangements to reclaim bonuses where performance subsequently declines or the business proves to be excessively risky. A spate of litigation is to be expected in respect of both issues.

Withholding bonuses

In February this year, the case of *Mouradian v Tradition Securities and Futures SA* [2009] All ER (D) 100 came before the Court of Appeal, on appeal from the Employment Appeal Tribunal. Mr Mouradian claimed that a number of costs were wrongly deducted by his employer from the bonus pool to which, he claimed, he and his team were entitled, thereby depleting the available amount. He argued this was an unlawful deduction of wages under section 13 of the Employment Rights Act 1996. The employer argued that the requirement under the Act that the wages be quantified was not met because there was an element of discretion to the payment (the relevant clause referred to the bonus pool being divided in such proportions as Mr Mouradian deemed appropriate subject to consultation with the CEO) and so the correct forum was not the EAT but the High Court and the correct claim was for damages for breach of contract. This was rejected by the EAT and the Court of Appeal which said that notwithstanding the provisions of the employment contract, in practice Mr Mouradian had total discretion to allocate bonuses and the amount claimed was quantifiable. This decision is beneficial to employees where the claim is straightforward, there is little or no discretion by the employer as to the bonus and the amount claimed is readily quantifiable, as EAT proceedings are generally quicker and cheaper than High Court proceedings.

More recently, this issue has resurfaced in the high profile claim brought in the High Court against Dresdner Kleinwort by a group of 72 employees who are suing the firm for non-payment of €33m worth of bonuses. The bank appears to be relying on a material adverse change clause as its justification for withholding bonuses. The claim is formulated as a breach of contract claim, which is the more traditional route for failure to pay a fixed or "formula" bonus, rather than the Mouradian-type claim. It will be interesting to watch this case unfold, particularly in times when institutions are under considerable financial pressure to cut costs, of which large bonuses form a significant part.

The regulatory approach to clawback of bonuses

In its August 2009 Feedback and Final Rules policy statement on Consultation Paper 09/10, the FSA has confirmed that its Code of Practice on remuneration policies will be incorporated into the FSA's Handbook and come into force on 1 January 2010 for large banks, building societies and broker dealers. Whilst the changes to policies and procedures must be in place by 1 January 2010, in response to an outcry during the consultation process, the policy statement also says that transitional arrangements for amendments to employment contracts that can be amended by the firm end on 31 March 2010 and transitional arrangements to amend or terminate other employment contracts end on 31 December 2010. The final version of the Code provides that remuneration policies must be consistent with effective risk management but does not specifically require firms to implement bonus clawback schemes, although there are veiled references to this in the guidance, including that bonus pool calculations be adjusted for current and future risk and that the performance related element of remuneration should not be based solely on the current financial year. This reflects the widely held political view across the G20 that remuneration has caused excessive risk taking due to the lack of accountability for the consequences.

Precedent?

There is precedent for clawback policies. In 2005/2006 F&C Asset Management was reported to have introduced contracts which were designed to prevent reward for failure. The relevant clause allowed for cash bonuses to be recouped from executives when they were "paid in error" because remuneration committees were unaware of the true financial standing of the executive's business division or the company at the time the bonus was awarded. Firms seeking to adopt such an approach now would inevitably face practical problems with having to renegotiate and rewrite contracts of employment for staff who have often grown accustomed to receiving "guaranteed" bonuses, whether express or implied through previous practice.

Even further back, bonus clawback and deferred bonus schemes were adopted by several firms in the late 1990s but were abandoned because it was felt that it led to a competitive disadvantage, one of the concerns currently being cited by the banking community about the proposed changes to the regulations on remuneration.

Enforcing clawback clauses

Inevitably, there will be considerable resistance by the recipient of the bonus to repay it and the larger the bonus the more willing he or she will be to devote resources to resisting a claim for enforcement and recovery by the employer. Equally, there will be a minimum level of bonus below which the employer is unlikely to commit to litigation, not least because of the potentially detrimental reputational impact of being perceived as an employer that tries to recover compensation for hard work months or years afterwards. Proving that the relevant performance targets were or were not met, or that a set of trades or deals which indirectly led to the bonus award later turned out to be too risky, will also be hard. Firms embarking on litigation will also need to be satisfied that the recipient either still has the cash or sufficient assets to satisfy a judgment.

Given the potential drawbacks to clawback schemes, firms may prefer to comply with the remuneration principles through increased use of deferred bonus schemes. Employees are far more likely to be accepting where a set of criteria is provided to them at the outset, which, if fulfilled, will entitle them to future payments in the following or subsequent financial years than where they receive the cash and then have to pay it back.

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