

DEFERRED VARIABLE REMUNERATION THE CODE'S INTERACTION WITH EXPRESS AND IMPLIED TERMS

RE-WRITING THE "DNA" OF THE EMPLOYMENT CONTRACT

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Introduction

1. The title of this series of talks asks whether or not the FSA has, in effect, torn up the employment contract. In certain important respects it has. The Capital Requirements Directive ("CRD3") and the FSA's proposed update to the Remuneration Code (the "Code") are likely to have a profound impact on the terms of contracts of employment going forward. However, more fundamentally, the new rules are likely to have a significant impact on the way in which the Courts construe the remuneration provisions in contracts of employment. In short the effect of CRD3 and the Code may be to re-write key parts of the "DNA" of the employment contract.
2. Much of the recent high value employment law has, unsurprisingly, centred on the financial services sector and the contractual mechanisms used to remunerate and retain investment bankers, inter-dealer brokers, hedge fund managers and similarly highly paid individuals. The relevant contractual remuneration provisions will often be complex but will usually comprise a combination of variable remuneration and fixed salary and be payable in part in cash and in part in stock. There will also, commonly, be provisions for deferral of a part of the remuneration with stock options vesting over a number of years
3. These complex provisions are open to abuse and challenge by both parties to the contract. The operation of the remuneration provisions has traditionally been reviewed by the Courts using the flexible tool of trust and confidence ("T&C"). The T&C term allows a balance *"to be*

struck between an employer's interest in managing his business as he sees fit and the employee's interest".¹

4. This paper considers how CRD3 and the Code are likely to inform the Courts' interpretation of the T&C term in the context of the remuneration provisions in the future. The paper focuses on the inter-relationship between the implied terms in the employment contract and the Code and asks whether the effect of the Code is to displace or modify the T&C term. The talk assumes a basic familiarity with the key provisions of the Code itself which has been covered elsewhere.

5. The Scheme of the talk is as follows:

A: WILL T&C "DRIVE" THE CODE OR WILL THE CODE CIRCUMSCRIBE T&C?

B: THE T&C TERM.

C: THE ROLE OF T&C AS A FETTER ON THE EMPLOYER'S DISCRETION.

D: HOW DO THE RELEVANT IMPLIED TERMS SIT WITH THE CODE?

A: WILL T&C "DRIVE" THE CODE OR WILL THE CODE CIRCUMSCRIBE T&C

6. The Code is designed to take on board the remuneration rules required by CRD3 and the Financial Services Act 2010 (the "FS Act"). The FSA has said that it does not intend the final rules to be super-equivalent to the CRD3 requirements unless required to do so by UK legislation.

7. Section 139A(9)(b) of the FS Act permits the FSA to make rules which render contract terms void. The FSA has exercised that power in relation to guaranteed bonuses, lack of deferral and replacement payments. Where a contractual provision is rendered void no question of a tension between the contract of employment and the Code arises. In relation to provisions which are not void, employees will be able to invoke a *contractual* right against the employer, even if performance by the employer places it in breach of the code.

¹ Per Lord Steyn in *Malik and Mahmud v BCCI*

8. In respect of the provisions which remain contractually enforceable some interesting grey areas arise, particularly where the employer retains a discretion. Is the discretion fettered by the Code, by the T&C term or both? Two obvious examples are *Malus adjustments*² and *Clawback*.³
9. In considering whether and how the new rules will inform the Courts' approach to the traditional role played by T&C in maintaining a balance between the interests of the employer and the interests of the employee it is necessary first to consider the purpose of and policy behind the rule changes.
10. The purpose of the CRD3 is summarised as follows:

*"In order to address the potentially detrimental effect of poorly designed remuneration structures on the sound management of risk and control of risk-taking behaviour by individuals, the requirements of Directive 2006/48/EC should be supplemented by an express obligation for credit institutions and investment firms to establish and maintain, for those categories of staff whose professional activities have a material impact on their risk profile, remuneration policies and practices that are consistent with effective risk management. Those categories of staff should include at least senior management, risk takers and control functions, and would normally include any employee whose total remuneration, including discretionary pensions benefits provisions, takes them into the same remuneration bracket as senior management and risk takers."*⁴

11. The FSA consultation paper summarises the policy as follows:

*"We believe that our proposals will contribute to greater market confidence by further aligning compensation practices with sound risk management. The proposals are aimed at curbing incentives that contribute to excessive risk-taking in the financial services industry, which can lead to failure of firms, systemic problems and a loss in confidence in the financial system."*⁵

12. How are those policy considerations likely to be reflected in the T&C term?

² A performance adjustment practice that allows firms to adjust the as-yet unvested portion of an individual's bonus to take account of developments after communication of the bonus

³ A performance adjustment practice that enables firms to demand payback of all or part of an individual's bonus that has already vested with the individual, to take account of investments after vesting.

⁴ CRD3 Recital 3

⁵ CP10/19, Annex 2

B: T&C TERM

13. The DNA of the modern employment contract is the T&C term. In order properly to understand how the Code is likely to shape employment contracts in the future is essential to understand how the Courts have used the T&C term to date.
14. In its classic formulation, it is expressed as a duty on the employer that the employer must not:
- “without reasonable and proper cause conduct [itself] in a manner calculated to or⁶ likely to destroy or seriously damage the relationship of trust and confidence between employer and employee”***
15. However, it has for some time been accepted that the duty is a *mutual* one. Lord Denning MR in **Woods**⁷ saw the employer’s duty as the “flip side” of the employee’s duty of fidelity. *“Just as a servant must be good and faithful, so an employer must be good and considerate.”*⁸ It is now common to treat the employee’s duty of fidelity (with its requirements of honesty and co-operation) as part of a single duty on both parties to maintain “mutual” trust: see e.g. **Neary v Dean of Westminster** [1999] IRLR 288.
16. Though originally developed largely as a means of enabling employees to complain of constructive dismissal when faced with oppressive behaviour by employers, the implied duty is now used by the courts in a wide variety of situations to regulate conduct on both sides which is not the subject of express terms. Sometimes it is even used to control the exercise, or influence the interpretation, of the express terms.⁹
17. The test of breach is objective. Indeed, the innocent party need not even know of the relevant conduct before it can be considered “trust destroying” (see **Malik & Mahmud v BCCI**

⁶ **Woods v WM Car Services** [1981] IRLR 347 applied in **Malik and Mahmud v BCCI** [1997] IRLR 462.

⁷ [1982] IRLR 413, CA

⁸ See Lord Denning MR at para 10 [1982] IRLR 413 at 415

⁹ Lord Steyn in **Malik and Mahmud** indicated that that the T&C was a default term capable of being excluded by express provisions. As an implied term it ought in principle to yield to express terms. But the courts have often been willing to allow the implied T & C term to “drive” the express terms rather than *vice versa*; see e.g. **Gogay v Herts CC** [2000] IRLR 703 **United Bank v Akhtar** [1989] IRLR 507

[1997] IRLR 462). However dealings between the parties may have some marginal effect “in setting the bar” for particular kinds of conduct: see e.g. **Horkulak v Cantor Fitzgerald** [2004] IRLR 942.

18. Since there can only be a breach of the term where the behaviour is so grave as to destroy or seriously damage the relationship, all breaches are repudiatory and thus, as a matter of contract entitle the other party to terminate.¹⁰
19. The T&C is a default term capable of being excluded by express provisions (per Lord Steyn in **Malik and Mahmud**). As an implied term T&C ought in principle to yield to express terms. But the courts have often been willing to allow the implied T & C term to “drive” the express terms rather than vice versa; see e.g. **Gogay v Herts CC** [2000] IRLR 703 and **United Bank v Akhtar** [1989] IRLR 507. In **Akhtar** the EAT held that the T&C term over-rode the express terms of the contract:¹¹

“we take it as inherent in what fell from Mr Justice Browne-Wilkinson that there may well be conduct which is either calculated or likely to destroy or seriously damage the relationship of confidence and trust between employer and employee, which a literal interpretation of the written words of the contract might appear to justify, and it is in this sense that we consider that in the field of employment law it is proper to imply an over-riding obligation in the terms used by Mr Justice Browne-Wilkinson, which is independent of, and in addition to, the literal interpretation of the actions which are permitted to the employer under the terms of the contract.”

C: THE ROLE OF T&C AS A FETTER ON THE EMPLOYER’S DISCRETION

20. If the employee contends that the failure to pay a bonus (or to pay a sufficiently large bonus), infringes the bounds of the T&C term, the Courts continue to apply the test of irrationality explained in **Horkulak v Cantor Fitzgerald** (above): see recently **Humphreys v Norilsk Nickel International (UK) Limited** [2010] EWHC 1867.
21. Notwithstanding that the touchstone in a bonus case is “irrationality”, pleading the T&C term will usually be an important plank in any claim and a failure to plead it may be fatal. In

¹⁰ See e.g. **BBCI v Ali** (No 2) [1999] IRLR 508 para 52(d) at p516 **Morrow v Safeway Stores** [2002] IRLR 9

¹¹ At paragraph 50, citing Browne-Wilkinson J. in **Woods**

Commerzbank AG v Keen [2007] IRLR 132 the Court of Appeal overturned the decision of the Judge and substituted an order for summary judgment in favour of the bank on the relevant part of the claim for a discretionary bonus. The Court noted that the claimant's case had not been pleaded or argued on the basis of a breach of the T&C term and held, per Jacob LJ at paragraph 110:

"I accept that the implied duty of trust and confidence between employer and employee will, generally, require an employer to give his reasons for the exercise of his discretion to pay or withhold a bonus and to identify the decision-maker. Absent such an obligation, exploitation would be all too easy, even if exploitation is not a word which springs immediately to mind in this appeal. But, in the different context of a claim for damages for breach of the implied term not to make an irrational award, a failure to give reasons or to identify the decision-maker will not necessarily establish irrationality. It is for the employee to establish the irrationality of the decision. He must be able to demonstrate some feature of the award, or the circumstances in which it was made, which tends to show its perversity. If he can do so, then the absence of any explanation, or a failure to identify the decision-maker will lend powerful support to his case. If there is nothing to show that the award is outwith the range of additional payments a reasonable employer, in similar circumstances, would award, I take the view that silence would not be sufficient to demonstrate irrationality."

22. An adventurous attempt was made by the employing bank to deploy the T&C term as a defence to a claim for bonuses which were due under the express terms of the contract. In **Fish v Dresdner Kleinwort** [2009] IRLR 1035 the High Court gave summary judgment for such bonuses, rejecting arguments that, in the financial crisis which had arisen since the bonuses had been agreed, senior executives were in breach of the implied term of trust and confidence in not forgoing payment. The duty of trust and confidence did not impinge on the individual's rights to payment under a freely negotiated agreement.

23. In **Bateman v Asda** [2010] IRLR 370 the EAT upheld the decision of an ET that a staff handbook gave the employer the power unilaterally to vary the terms and conditions of its employees as to pay. The EAT held that ET had not erred in law in holding that under the terms of the staff handbook the employer could alter the terms of the employment contract without obtaining the further consent of the claimants. An employer can reserve the ability to change a particular aspect of the contract unilaterally, although clear language is required to do so.¹² An important consideration was the extent to which such a power could in practice be confined by the T&C term. The EAT held that a unilateral right to vary should be exercised

¹² Following **Wandsworth London Borough Council v D'Silva** [1998] IRLR 193 CA

in a way that does not breach the T&C term. However, it noted that the claimants had not sought to argue before the ET that the T&C term had, on the facts, been breached.

24. Although T&C acts as a fetter on the contractual terms, the infringement of statutory rights does not necessarily entail a breach of T&C. Stated broadly, it is not immediately obvious why, for example, directly discriminatory action e.g. on grounds of race should not be always of such a character to destroy or seriously damage trust and confidence, nor how unlawful direct discrimination could ever be said to be done with “reasonable and proper cause”. ***Amnesty International v Ahmed*** [2009] IRLR 884 does however provide some guidance. In the EAT Underhill J., accepted that in most cases conduct proscribed by the anti-discrimination legislation would entail a breach of the T&C term. In the case before him however the respondent charity had declined to appoint a Sudanese Arab to the position of researcher for Sudan because of long-standing concerns about whether a national of a state under investigation by the charity would be seen as impartial. The EAT held that this amounted to unlawful direct racial discrimination. Whilst views could legitimately differ about the Charity’s policy the EAT accepted that the underlying reasons for the policy were “serious and genuine”. It concluded that the employer could *not* be said to have acted “without reasonable or proper cause” so as to breach the implied term of trust and confidence.

25. The focus of Underhill J. on “***reasonable and proper cause***” in that case provides a useful signpost as to the way in which the Courts may use the Code to circumscribe the T&C term.

D: HOW DO THE RELEVANT IMPLIED TERMS SIT WITH THE CODE?

26. The Code provides a powerful policy argument for an employer who seeks to limit the potentially far reaching ambit of the T&C term and the duty not to act irrationally when exercising a discretion in relation to variable remuneration.

27. An employer who acts in accordance with the Code will have “reasonable and proper cause” for so acting. If the employer has reasonable and proper cause there will be no breach of

T&C. Similarly it will not be irrational to take into account the requirements of the Code, for example in relation to malus adjustments where the Code provides that:

19.3.48RA firm must ensure that any variable remuneration, including a deferred portion, is paid or vests only if it is sustainable according to the financial situation of the firm as a whole, and justified according to the performance of the firm, the business unit and the individual concerned.

19.3.49 E (1) A firm should reduce unvested deferred variable remuneration when, as a minimum:

(a) there is reasonable evidence of employee misbehaviour or material error;

(b) the firm or the relevant business unit suffers a material downturn in its financial performance;

(c) the firm or the relevant business unit suffers a material failure of risk management.

(2) For performance adjustment purposes, awards of deferred variable remuneration made in shares or other non-cash instruments should provide the ability for the firm to reduce the number of shares or other non-cash instruments.

28. Perhaps more interestingly, it seems likely that the broader policy objectives underscored by CRD3 and the Code will be weighed by the Court in the balance when considering whether or not an employer has either breached T&C or complied with its duty not to act irrationally when paying a bonus. These arguments might be deployed by the employer even where the employee in question is neither “Code Staff” nor “Senior Management”. Thus even if it can be said that the particular employee falls outwith the scope of the Code the employer might nevertheless argue with some force that having addressed its mind to the policy considerations which underpin the Code it considered it appropriate to exercise its discretion in a particular way.

29. It is inevitable that the new avenues of argument will be opened up for employers. By way of example:

- (1) In ***Takacs v Barclays Services Jersey Ltd*** [2006] IRLR 877 the Court held that a claimant had a real prospect of establishing that the employers were in breach of the implied duty of trust and confidence and that that breach (a lack of co-operation) prevented him from attaining the sales credits needed to qualify for an additional bonus. However, under the Code, it is difficult to see how any obligation to co-operate could trump a properly made ex-post risk adjustment.

(2) In *A v Dresdner Kleinwort Ltd & Ors* [2010] EWHC 1249¹³ the claimants allege that Dresdner failed to honour promise of minimum bonus pool. Dresdner's decision to reduce the awards by 90% is said to be irrational or perverse, or in breach of the implied term of trust and confidence. The case (which thus far has been allowed to proceed in part) would undoubtedly be more difficult for claimants if had arisen after the new rules were in play. Those rules would reinforce an important aspect of Dresdner's case, namely, that it was entitled to make the reductions as consequence of the credit crunch.

Conclusions - drawing the strands together

30. The Code is likely to have a significant impact in the way in which the Courts use the T&C and the touchstone of irrationality to maintain the balance between the interests of the employee and the employer in the context of financial sector pay. The ramifications of the Code are likely to go beyond its black and white provisions. The policy which underlies the Code is likely to provide powerful additional arguments to employers seeking to defend ambitious or inventive claims based upon alleged breaches of T&C. However, there remains plenty of room for optimism for those advising employees. It is likely that T&C will remain a useful tool where there are shades of grey and the Courts will continue to use T&C to ensure that oppressive or capricious conduct on the part of the employer is not permitted.

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¹³ The decision of Simon J. is due to come before the CA in February 2011.