Notes

Discretionary Bonus Awards, UCTA and the Duty to Give Reasons

Commerzbank AG v Keen
[2007] IRLR 132 (CA)

That so many of the decisions in recent years addressing the exercise by employers of their discretionary powers have arisen in the context of challenges to discretionary bonus awards made by employers in the financial services sector and other similar areas no doubt reflects the quantum of many such claims. *Commerzbank AG v Keen* is such a decision and, whilst an appellate decision on an application for summary judgment to dismiss the employee's claim, is of interest for what it says about the application of the Unfair Contract Terms Act 1977 ('UCTA') to the contract of employment, the standard of proof required to demonstrate that an employer's exercise of a contractual discretion is in breach of contract and whether an employer is required to provide its employees with reasons for its decisions.

Mr Keen claimed damages in respect of his employer's decisions as to bonus awards in respect of three particular years. In relation to the first two of the three bonus decisions which he challenged, Mr Keen argued that the bonuses which he received were determined irrationally or perversely and that higher awards should have been made. In relation to the third year, not only did Mr Keen contend that the failure to award him any bonus at all was irrational; he also argued that his employer's reliance in denying him a bonus on a provision of his contract, to the effect that he was not entitled to any bonus payment if he was not employed at the time of payment of the bonus (as was the case), fell foul of section 3 of UCTA.

The challenge to the first two bonus decisions was based on the implied term (which the defendant bank did not contest) that the employer would not exercise irrationally or perversely the discretion which it had in relation to bonus awards. At first instance, the summary judgment application in respect of the first two years' bonus awards was rejected for a variety of reasons which in the view of Morison J justified a trial on the merits, including the fact that the bank had provided very little evidence as to who took the decisions in question and why, the need to examine

contemporaneous documentary evidence, and the lack of any explanation for why Mr Keen's line manager's recommendations as to his bonus were not followed.

In overturning the first instance decision, the Court of Appeal relied on a number of relevant authorities (*Horkulak v Cantor Fitzgerald* [2004] IRLR 942 CA, *Clark v Nomura International plc* [2000] IRLR 766 HC and *Clark v BET plc* [1997] IRLR 348 HC). Together these establish the principle that employees are entitled (in the words of Potter LJ in *Horkulak* at para 46, cited by Mummery LJ in *Keen* at para 55) to a 'bona fide and rational exercise [by their employer] of their discretion as to whether or not to pay him a bonus and in what sum'.

In a statement from which employers will take great comfort, and upon which they will no doubt place great reliance in future disputes, Mummery LJ stated (at para 69) that '[i]t would require an overwhelming case to persuade the court to find that the level of a discretionary bonus payment was irrational or perverse in an area where so much must depend on the discretionary judgment of the bank in fluctuating markets and labour conditions'.

On this basis, despite the grounds of challenge to the bank's bonus decisions to which the trial judge referred, Mr Keen's claim was found to have no real prospect of success, the bank having provided explanations in pre-litigation correspondence as to its bonus decisions. The relevant bonus decisions were not irrational on their face nor was there any independent evidence to support the argument of irrationality. Whilst consistent with authority, the stringency of the test applied in determining whether to allow the bonus dispute to proceed to trial reinforces the difficulty of attempting to challenge employers' discretionary bonus decisions.

The failure to award a bonus to Mr Keen in relation to the third year in question, on the basis of the contractual provision that he was not eligible to receive any bonus payment if he was not employed at the date for payment of a particular year's bonus, was challenged on two grounds. First, the bank's discretion as to the timing of bonus payments was contended to have been exercised irrationally. This argument failed as bonuses were paid by the defendant bank to its staff generally in relation to the particular year in question at the same time as in previous years and there was therefore 'nothing unusual' (per Mummery LJ at para 74) about their timing and the decision accordingly not to award Mr Keen a bonus. Second, it was argued that the contractual provision in question fell foul of section 3 of UCTA. Mr Keen contended that the provision in question rendered a contractual performance substantially different from that which was reasonably expected of the bank (i.e. no payment of bonus despite Mr Keen having worked for part of the relevant year) and therefore was invalidated by section 3(2)(b) of UCTA.

In addressing this argument, the issue needed to be resolved of whether UCTA engaged at all, its section 3 providing that the provisions of that section apply 'as between contracting parties where one of them deals as a consumer or on the other's written standard terms of business'. Mummery LJ observed that the

authorities on the issue of UCTA's application to employment contracts (*Bridgen v American Express Bank Limited* [2000] IRLR 94, HC and *Peninsula Services Limited v Sweeney* [2004] IRLR 49, EAT) were not entirely satisfactory. He proceeded to focus his analysis not on whether section 3 of UCTA generally covers employment contracts but whether a 'contract term' in an employment contract falls within its scope. He approvingly adopted Professor Freedland's analysis that employment contracts do not naturally fit within the categories either of consumer contracts or written standard terms of business (see *The Personal Contract of Employment* (Oxford: OUP, 2003) at p 191). Such arrangements tend to relate to recipients of goods or services as distinct from employment contracts where employees are providers of their services. Moreover, as Mummery LJ observed, the relevant contractual terms in Mr Keen's contract were not the bank's written terms of business—its business is that of banking and the provisions of its employees' contracts as to bonus entitlements were terms of remuneration not of business. Accordingly, section 3 of UCTA was held not to apply to Mr Keen's contract of employment insofar as it related to his bonus entitlements as the relevant contract term was not part of written standard terms of business nor was he dealing with the bank as a consumer.

That UCTA has limited application to contracts of employment is surely a common sense result consistent with the view (also referred to by Mummery LJ in *Keen*) of the Law Commission in its Report on Unfair Terms in Contracts (Cm 6464, February 2005). The Law Commission's conclusion was that, in the context of the employment relationship, the protection of section 3 of UCTA should extend to 'standard' terms applying to 'additional services' such as health plans and holidays but that it was not appropriate generally to treat employment contracts similarly to consumer contracts. The decision in *Keen* is consistent with the view that the regulation of employment contracts is best effected by statute specifically and expressly intended to achieve appropriate employment protection and by the common law relating to implied terms rather than by legislation, such as UCTA, developed in another context for other purposes.

Perhaps the most intriguing aspect of the *Keen* decision is the commentary, made almost in passing, on the issue of whether the implied obligation to maintain trust and confidence imposes a duty on an employer to give reasons for its discretionary bonus decisions. The relevance of reasons in disputes over discretionary bonuses depends on the basis of the claimant employee's claim. If, as was the case in *Keen*, the claim is based on an alleged irrational exercise of the employer's discretion, the employer must show a prima facie case of irrationality before the employer is required to justify its position. In the context of a claim based on irrationality, failure on the part of the employer to provide reasons for its bonus decisions is only of evidential significance. As Moses LJ put it in *Keen* (at para 110), 'silence would not be sufficient to demonstrate irrationality'.

However, the Court of Appeal considered the position to be different in the case of claims based on the implied duty to maintain trust and confidence. It was indicated, albeit obiter, that the implied obligation to maintain trust and confidence imposes a duty on the employer 'generally … to give his reasons for the exercise of his discretion to pay or withhold a bonus and to identify the decision-maker' (per Moses LJ at para 110). As Mummery LJ put it (at para 44), 'consistent with this duty [to maintain trust and confidence] an employer ought to supply an employee with an explanation of the reasons for the exercise of a discretion in respect of additional pay [and] unless there is a good reason to the contrary, the explanation ought to be given by the person(s) responsible for the decision … '. Such an obligation, if established, could be very significant in light of the fact that it has been held (although doubted subsequently) that every breach of the implied term of trust and confidence is a repudiatory breach of contract (*Morrow v Safeway Stores plc* [2002] IRLR 9 EAT).

The judgments in *Keen* do not set out any detailed reasoning justifying or explaining the establishment of an implied duty to give reasons either in the specific context of discretionary bonus awards or more generally. Rather, an implied obligation to give reasons for discretionary bonus decisions is simply assumed or asserted to flow from the implied term as to mutual trust and confidence. Nor is any detail provided as to the substantive nature of the supposed obligation, for example, in terms of the level of detail required to be given by an employer by way of its reasons for a discretionary bonus decision. It is therefore worthwhile considering whether and how such an extension of the implied obligation to maintain trust and confidence should be established.

It might be thought that there is little material from which support for an implied obligation to give reasons in the employment context could be derived whether in the limited context of discretionary bonuses or more generally. Whilst Lord Hoffman may (in *Malik v BCCI* [1997] ICR 606 HL) have indicated that implied terms may be discerned by analogy with statute, there is no such analogy to draw in this context as the statutory duty imposed on employers to give reasons to employees only arises in relation to dismissals. Even in the context of public law (which regulates the exercise of discretionary power and whose principles have been argued to an extent to have contributed to the development of the implied obligation to maintain trust and confidence in the employment relationship), there is no general rule of natural justice requiring reasons to be given for administrative decisions. Previous attempts to require employers, by way of a term implied into the contract of employment, to give reasons for their decisions have failed. For instance, in the context of the contractual ability to suspend an employee from work, in *McLory v Post Office* [1993] IRLR 159 HC, the contention was rejected that the implied duty to maintain trust and confidence required the employer to give its reasons for a decision to suspend

an employee from his employment. The importation of public law principles of natural justice into the contractual employment relationship was rejected on the basis that it was 'neither necessary to imply such a term for the contract of employment to function nor [was] it obvious that the parties would have envisaged such a term' (at para 159).

Against this, the development of the implied term as to trust and confidence as a mode of regulation of the employment relationship has extended to the imposition of positive obligations in a number of instances and therefore could be seen as capable of creating a duty to give reasons. The interpretation of the implied duty to maintain trust and confidence as a 'portmanteau' obligation (per Lord Nicholls in *Malik*) provides the gateway through which an obligation to give reasons can be implied without necessarily the need to detailed resort to tests of implication such as the officious bystander or 'business efficacy'. Cases such as *Scally v Southern Health & Social Services Board* [1991] IRLR 522 HL (with regard to the obligation to provide pension information not readily available to the employee) and *Reid v Rush & Tompkins Group* [1989] IRLR 265 CA (in relation to the obligation to advise employees of the risks of working overseas), whilst imposing procedural rather than substantive obligations upon employers, demonstrate a willingness on the part of the courts to imply in the employment context obligations of disclosure of information, albeit strictly limited in scope.

The fact that an obligation to provide information can be implied into the contract of employment in certain circumstances could, together with the implied duty of cooperation, be seen as supportive of an implied obligation to give reasons, not least with a view to facilitating the operation and maintenance of the employment relationship by encouraging transparency on the part of employers with regard to their decisions, thereby potentially reducing the risk of disputes with employees. Such an implied obligation could be viewed as a further aspect of Freedland's concept of a doctrine of fair management and performance in relation to the personal contract of employment (see *The Personal Employment Contract*, pp 223–30).

There must, however, be considerable doubt as to whether it is appropriate or necessary to imply into the contract of employment a duty to give reasons, even in the limited context of bonus awards. It can be argued that a duty to give reasons would be an unnecessary extension of the obligations imposed on employers by the common law and one whose proceduralism and associated administrative burdens would inhibit the efficiency of the performance of the employment contract. In the particular context of discretionary bonus awards, it is agreed that an implied obligation to provide reasons is not required to enable employees to bring claims nor would its establishment necessarily resolve or avert disputes.

On this analysis, the view is taken that employees who wish to challenge their employers' discretionary bonus decisions already have adequate means of

establishing whether a claim can be brought without an obligation on employers to provide detailed reasoning for those bonus awards. The bringing of a formal grievance will, not least pursuant to the implied obligation to consider employees' grievances established by *W.A. Goold v Pearmak* [1995] IRLR 516 EAT, in practice require the employer to address a complaint and explain its position. This practical impetus to address complaints is further reinforced if (as may often be the case) the subject matter of the grievance falls within the scope of the statutory grievance procedures prescribed by the Employment Act 2002 and the Employment Act 2002 (Dispute Resolution) Regulations 2004 SI 2004/752. In those circumstances, the employer is incentivised to respond substantively to the employee's complaint by the potential uplift of 50% to the recoverable compensation consequent upon failure to conduct the required procedure. In cases of suspected unlawful discrimination, use of a statutory questionnaire will, if responded to, enable an employee to ascertain whether there is a potential claim, whether for equal pay, sex or race discrimination or otherwise, in relation to a bonus award and, if ignored or evasively answered, can lead to inferences being drawn adverse to the employer. Admittedly, these factors will not apply in all cases. Nonetheless, pre-litigation correspondence ultimately has the potential, if the parties comply with the relevant pre-action protocols, to demonstrate whether an employee has a potential claim.

The development of an implied obligation to give reasons would also need to address concerns with regard to its substantive content in terms of the degree of detail required to be given by way of reasons for a bonus award. Imprecision in its substantive context would further undermine any perceived value in an implied obligation already of doubtful utility and could lead to uncertainty and dispute. Discretionary decisions may not lend themselves to detailed exposition, whilst nonetheless being rational and legally defensible. Employers would also be concerned at the risk in practical terms to the confidentiality of their remuneration review processes of being required as a general rule to formally explain their decisions. Moreover, the establishment of an implied duty to give reasons in the limited context of discretionary bonus awards could be seen as the beginning of a move towards establishing a similar obligation in the comparable area of salary reviews or even in relation to discretionary powers more generally. Made too general, an implied duty to give reasons would, it can be argued, interfere unduly with the managerial prerogative in relation to which employees are already protected by the fact that they are only required to comply with the employer's lawful and reasonable instructions.

Freedland describes three ways in which the implied obligation to maintain trust and confidence can be expounded—as a precise formulation, a grouping of implied obligations or a broad set of approaches or behavioural standards (see *The Personal Employment Contract* at p 158). It is submitted that, even if it is to be

established, an implied duty to give reasons should be limited, as one of the grouping of obligations to which the implied term as to trust and confidence gives rise, to the specific context of discretionary bonus awards. Despite the concerns raised in this note, principally to the effect that the implied duty in question is unnecessary and potentially impedes the efficiency of the operation of the employment contract, the Court of Appeal's comments in *Keen* clearly demonstrate a receptiveness to the establishment of an implied obligation to give reasons in the context at the very least of discretionary bonus awards. It will be interesting to see if subsequent jurisprudence builds upon this apparent foundation.

CHARLES WYNN-EVANS* doi:10.1093/indlaw/dwm006

* Dechert LLP, email: *charles.wynnevans@dechert.com*