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BONUS PAYMENT

absolute discretion and serious misconduct

Employment contracts commonly include provisions that grant employees a bonus payment or right to participate in a bonus scheme. It is not uncommon for such contractual provisions to stipulate that the bonus payment is subject to the employer's absolute discretion and the employee's right to it will be forfeited if the employee engages in serious misconduct.

An employee's entitlement to bonus payments is a matter of both construction and commercial context. Accordingly, the wording of an employment contract and its underlying purpose will ultimately determine whether an employer is bound to make bonus payments.

This article reviews recent case law to shed light on the position taken by the courts on bonus payments and proffers answers to the following questions: (i) Does the employer have an absolute discretion to withhold bonus payments? (ii) How does a finding of serious misconduct affect bonus payments?

INTRODUCTION

The question whether an employee has a legally enforceable right to a discretionary bonus is a function of many variables and depends to a large extent on the given circumstances, particularly the terms and conditions of the relevant contract

of employment and company policies. The employer's discretion should be understood in the context of the proper scope and content of the contract.¹

First, it is pertinent to determine whether the bonus provision is expressed in terms which (i) state that it is a mere right to participate in the bonus scheme; (ii) guarantee the bonus payment unconditionally; or (iii) subject the bonus payment to the employer's absolute discretion. This is a matter of construction, requiring the operation of the bonus provision to be construed reasonably.²

ABSOLUTE DISCRETION

Discretionary bonuses give the employer flexibility in considering whether or not to make a bonus payment either during employment or upon termination, the level of the bonus payment and the terms and conditions under which the bonus will be paid.

The general assumption is that if a bonus is discretionary

in nature, an employer has no contractual obligation to pay the bonus. This proposition reflects the fundamental legal principle confirmed in *Lavarack v Woods of Colchester Ltd*,³ that damages for wrongful dismissal could not confer on an employee extra benefits that the contract did not oblige the employer to confer.

However, there are English and Australian authorities limiting the extent of the employer's absolute discretion to withhold bonus payments. The law in England is reflected in cases such as *Clark v Nomura International plc*,⁴ this case confirms that even when a discretion appears to be unfettered, the courts are willing to imply a term into the bonus scheme that an employer will not exercise its discretion perversely or irrationally. The courts will consider whether or not a reasonable employer would have exercised its discretion in that way. In *Clark v Nomura International plc*, the High Court ruled that the employer's decision not to pay bonuses to the employee, in circumstances where he had earned the bank profits in excess of £13.75 million, was an irrational and perverse exercise of its contractual discretion. The court noted that the employer had fettered its discretion by specifying that bonus payment was dependent upon 'individual performance'. The employee had made substantial profits for the employer and was a high performer. Similarly, in *Horkulak v Cantor Fitzgerald International*,⁵ the Court of Appeal held that the discretion in awarding a bonus had to be exercised honestly and in good faith, not capriciously or arbitrarily.

In Australia, the Victorian Supreme Court approved and adopted the principle in English law in *Eshuys v St Barbara Limited*,⁶ holding that all discretionary bonus schemes shall carry with them an implied term that the employer's discretion will not be exercised 'capriciously, arbitrarily, irrationally or perversely'. However, the court added that these principles should be applied with an understanding of the particular commercial context in which the contract was executed.⁷

The law in Australia was clarified in *Silverbrook Research Pty Ltd v Lindley*.⁸ In *Silverbrook* the court held that the question of whether an employee can enforce a discretionary bonus is a matter of reasonable construction of the relevant contract.⁹ The contract cannot be construed so as to permit the employer to withhold the bonus capriciously or arbitrarily or unreasonably.¹⁰ Basically, where the parties have agreed on set objectives, parameters and triggers that will govern the payment of the bonus, it will be a breach of contract for the employer to exercise its discretion in a manner not compatible with those agreed parameters. Consequently, the employer cannot exercise its discretion so as to effectively deny the subject matter of the bonus provision or decide arbitrarily, capriciously or unreasonably that it need not pay the bonus, where the set objectives have been satisfied. The employer is expected to exercise its discretion honestly and conformably with the purpose of the contract.¹¹

The court also noted that the probability that the employer will exercise its discretion in favour of the employee is a valuable opportunity. As such, the aggrieved employee can sue the employer for damages for loss of a valuable

commercial opportunity where the loss of the opportunity is the consequence of the employer's breach of contract and the loss is not too remote. The opportunity or chance is to be measured by the probabilities and possibilities.¹²

In 'absolute discretion' cases, the courts strive to strike a balance between the principle that they will not rewrite the contracts between equal contracting parties and the need to ensure that there is remedy available to an employee where the employer has acted capriciously or unreasonably. Nevertheless, the court's role is not to interfere with an employer's discretion merely because it would have come to a different decision.¹³ Similarly, the courts will not attempt to second guess the employer's evaluation in retrospect, conduct a merits review as to whether the decisions were fair and just,¹⁴ or query the level of a discretionary bonus paid to an employee.¹⁵

IMPLIED TERMS

A question that arises where the employee has alleged breach of contract in bonus payment cases is whether Australian law implies terms (like mutual trust and confidence obligation, and good faith) into the contract of employment as a restraint on the possible arbitrary exercise of contractual discretions in employment contracts.

In *Russo v Westpac Banking Corporation*,¹⁶ the Federal Circuit Court of Australia upheld and enforced discretionary bonus schemes even though the employer insisted it had absolute discretion in its decision not to make an *ex gratia* payment to a retrenched ex-employee. The employee argued that the fact that a bonus scheme is discretionary, or that the relevant contractual right is limited to an eligibility to participate in a bonus scheme, does not (i) mean that the exercise of the discretion has no contractual force; (ii) support a party to act in breach of its obligations; and/or (iii) prevent an employee from recovering damages (including for loss of a chance) in respect of such breaches.¹⁷ The employer contended that its exercise of the discretion had no contractual force because the documents entitling the employer to the discretion were its policy documents, which it argued had no contractual force.

Furthermore, the employee argued that two terms were implied¹⁸ into his employment contract – namely, good faith and the term derived from the *Silverbrook* decision (*that the employer would not withhold the bonus capriciously, arbitrarily or unreasonably and that the discretion would be exercised honestly, conformably with the purpose of the contract*). The employee's contention was that the implied terms were necessary¹⁹ to give effect to the benefit of the employment contract such that, if those terms were not implied, the contractual benefit is rendered worthless.²⁰ However, the purported implied terms were inconsistent with the words 'complete discretion' and 'absolute discretion' as used in the employment contract.

The Federal Circuit Court judgment²¹ confirmed that despite the High Court's decision in *Barker*,²² *Silverbrook* was good law. Hence, it didn't really matter whether the *Silverbrook* decision was achieved by a process of implication or construction, provided the same result is achieved.



Notably in *Barker*, the High Court unanimously found that, under the common law of Australia, the class of contracts of employment did not contain an implied term of mutual trust and confidence. The court rejected the existence of the implied term on two grounds: the implied term did not meet the criteria of the 'necessity' principle²³ for the recognition of novel implied terms in law; and because there was a possibility that the implied term may be inconsistent with other express terms contained in the applicant's contract of employment.²⁴ However, the High Court left open the question of whether there is a general obligation to act in good faith in the performance of contracts.²⁵

With respect to implication of terms of fact, the process of implication is a process of construction in ascertaining the meaning of the contract and not the inclusion of terms based on what a reasonable person would have agreed to.²⁶ Basically, the implied terms cannot contradict or be inconsistent with 'an express term'.²⁷

In *Silverbrook*, it is worth noting that their honours did not follow the English mechanism of implying terms into the contract. Rather, the court stressed that the bonus provision should be construed reasonably, understanding that the operation of the discretion was a matter of construction requiring an appreciation of the scope and content of the contract as well as the obligations and entitlements therein.²⁸ In *Russo*, the court found that the determination of whether the employer had exercised its discretion properly must be undertaken by reference to the purpose of the employer's redundancy policy.²⁹ These authorities further support the view that constraint is achieved via construction rather than by implication, and whether an employee can enforce a discretionary bonus is a matter of construction.

SERIOUS MISCONDUCT AND FORFEITURE CLAUSES

Bonus schemes are usually structured to predicate eligibility for payment on certain criteria, including the employee's conduct. Such schemes often include provisions which expressly state that the consequence of a serious misconduct finding will include summary dismissal, forfeiture, clawback or disgorgement of incentive benefits promised (including benefits already earned and accrued) under the contract of employment ('forfeiture clause').

This section examines the (i) definition of serious misconduct that can validly trigger the operation of a forfeiture clause; (ii) circumstances in which the courts have enforced such clauses; and (iii) justification for the enforcement of a forfeiture clause.

The common law recognises that an employee may be summarily dismissed for serious misconduct and may forfeit the right to compensation if he/she engages in conduct that is inconsistent with his or her duties as an employee. However, there is no universally acceptable definition of serious misconduct. Also, there is no rule of law that defines the degree of misconduct that would justify dismissal without notice.³⁰

The interpretation of 'serious misconduct' has received consideration in case law. Serious misconduct has been defined as 'conduct that is so seriously in breach of the contract that by standards of fairness and justice the employer should not be bound to continue the employment'.³¹ It has also been defined as conduct that is 'incompatible with the fulfilment of the employee's duty or involved an opposition, or conflict between his interest and his duty to his employer or impeded the faithful performance of his obligations, or is destructive of the necessary confidence between employer and employee'.³²

For the conduct in question to justify dismissal, it must be of a serious nature involving a repudiation of the essential obligations under the contract.³³ Serious misconduct often includes but is not limited to fraud, negligent or intentional misrepresentations, malfeasance, misappropriation or diversion of corporate assets or business opportunities, acts of disloyalty, and the commission of illegal acts.³⁴

AUTHORITIES ON SERIOUS MISCONDUCT AND BONUS PAYMENT

*Downer EDI Limited v Gillies*³⁵

In determining whether particular conduct constitutes serious misconduct, subjective belief and motivation may be relevant but not determinative.³⁶ Subjective belief will be relevant if the conduct is capable of an innocent construction compatible with the employment relationship, as well as being capable of a construction that was incompatible with the employment relationship.³⁷

In *Downer*, the court considered whether the employee's conduct was inconsistent and incompatible with his duty as the managing director and CEO. The Court of Appeal found that there was evidence to conclude that there was serious misconduct. Any assessment of allegations of misconduct had to be made objectively, taking into consideration his fiduciary duties in equity (honesty and loyalty) and duties under the *Corporations Act 2001* (Cth) (Act).³⁸ Conduct deemed by the court to constitute serious misconduct included exposing the employer to reputational risk; breach of ss180 and 181 of the Act; possible breach of s18 of the Act; failure to discharge his duties with a reasonable degree of care and diligence; and using his employer's funds for an improper purpose.

The next question before the court was the contractual consequences of the finding of serious misconduct. This, the court stressed, depended upon the proper construction of the contract.³⁹ The court noted that the forfeiture clause in the employment contract should be construed both in the context of the common law and in accordance with honest commercial common sense. Noting that the employer was entitled, upon discovery of the employee's conduct, to terminate for serious misconduct, the court held that the

employer was not liable to pay monies forfeited as a result of the operation of the forfeiture clause.

Bibby v Sharma⁴⁰

Once an employer forms the opinion that the conduct in question constitutes serious misconduct justifying dismissal, they should ascertain with clarity the particular contractual right to terminate that is triggered, considering that a contract of employment will normally provide the employer with multiple rights of termination.

In *Bibby v Sharma*, the employer decided to terminate the employee's contract at an earlier date, relying on a termination for convenience provision, which entitled the employee to six months payment and a special bonus valued at \$1.4 million. At the time of termination, the employer was aware of allegations of serious misconduct against the employee, but elected to proceed under the termination for convenience provision, to avoid an awkward situation. Subsequently, the employer sought to rely on the forfeiture clause in the contract to justify its earlier termination, citing the principle in *Shepherd v Felt & Textiles of Australia Ltd.*⁴¹ Notably, this principle had been successfully applied in *Downer*. If the employer's submission was accepted, the employee would lose the right to the termination and bonus payments.

Citing Professor Carter,⁴² the court found⁴³ that where a party has more than one right of termination at the time of its election to terminate a contract, it is necessary to identify whether the rights are independent or concurrent. Independent rights of termination arise at different times, whereas concurrent rights of termination arise if two or more rights of termination arise from the same event. In the court's view, the two different rights of termination in *Bibby* did not operate concurrently. The trigger for each termination clause arose in respect of different events and at different times. Consequently, the employer could not rely on the forfeiture clause to withhold the termination and bonus payments.

PURPOSE AND JUSTIFICATION OF FORFEITURE CLAUSES

The consequence of an employee's violation of a serious misconduct provision may include summary dismissal; forfeiture of any bonuses which have been earned but not paid; an obligation to disgorge compensation previously received (a clawback); or both forfeiture and clawback.⁴⁴ Forfeiture clauses are broadly used in executive contracts to provide a disincentive for executives to engage in misconduct. Thus, the question of whether a forfeiture clause is legally enforceable depends on the reasonable construction of the contract and the circumstances of the employee's termination.

Arguably, forfeiture clauses can be applied capriciously but validly to deprive an employee of acquired rights to bonus payments. However, there is a reasonable presumption that courts will refuse to require restitution of compensation or forfeiture where it would be inequitable to do so. In any case, considering that the role of the court is limited to construing the contract to reflect the objective intention of the parties, if the parties have agreed that the employee will forfeit bonus payments already earned and accrued prior to termination,

then there is not much the court can do to rewrite this term of the contract.

Forfeiture clauses can operate to give the employer the benefit of valuable services provided by the employee while depriving the employee of benefits already accrued under the contract.⁴⁵ Nevertheless, the operation of these clauses can be justified on the basis that the employee has acted without diligence and fidelity, or has taken a position wholly inconsistent with that of agent for his employer⁴⁶ and, as such, should lose his or her right to compensation.

CONCLUSION

Given the reliance placed on the wordings of the employment contract and the possibility that the contract can reasonably be construed to enable the employer to benefit at the employee's expense, the onus is on the employee to understand and contemplate the possible operation of forfeiture clauses prior to executing the contract. Also, in the absence of express provisions reflecting the intention of the contracting parties to contract otherwise, a more equitable approach would be for the courts to adopt a mechanism which facilitates the enforcement of a forfeiture clause only where the serious misconduct is tantamount to fraud or dishonesty, or where the employee has benefited at the expense of the employer. In cases where there is no fraud or dishonesty, the employer has not suffered any loss and the employee had earned the bonus payment prior to termination, it is questionable whether the law should aid the employer to benefit from valuable services already rendered by the employee. ■

Notes: 1 *Silverbrook Research Pty Ltd v Lindley* [2010] NSWCA 357 at [5]. 2 At [5]. 3 [1967] 1 QB 278. 4 [2000] IRLR 766. 5 [2004] EWCA Civ 1287. 6 [2011] VSC 125. 7 At [126]. 8 [2010] NSWCA 357. 9 At [5]. 10 At [5]. 11 At [6]. 12 *Sellars v Adelaide Petroleum NL* [1994] HCA 4; 179 CLR 332 at 349. 13 *Russo v Westpac Banking Corporation* [2015] FCCA 1086 at [105]. 14 At [106]. 15 *Ridgway v JP Morgan Chase Bank National Association* [2007] EWHC 1325 (QB). 16 [2015] FCCA 1086. 17 *Russo*, see note 13 above, at [73]. 18 At [277]. 19 *Commonwealth Bank of Australia v Barker* [2014] HCA 32 at [29] per French CJ, Bell and Keane JJ. 20 *Russo*, note 13 above, at [278]. 21 At [280]. 22 *Commonwealth Bank of Australia v Barker* [2014] HCA 32. 23 At [280] per French CJ, Bell and Keane JJ. 24 *Russo*, note 13 above, at [25]. 25 *Barker*, see note 19 above, at [42]. 26 *Ibid* at [22]; [25]. 27 *Russo*, see note 13 above, at [122]. 28 *Silverbrook*, see note 1 above. 29 *Russo*, see note 13 above, at [103]. 30 *Rankin v Marine Power International Pty Ltd* (2001) 107 IR 117 at [240] (Gillard J). 31 *North v Television Corporation Ltd* (1976) 11 ALR 599 at 608-9 (Smithers and Evatt JJ). 32 *Blyth Chemicals Ltd v Bushnell* (1933) 49 CLR 66 at 80-81. 33 *Rankin*, see note 30 above, at [250] (Gillard J). 34 R Wood, 'Bad Boys (and Girls) Get Clawed Back', *Benefits Law Journal*, Vol. 18 No. 2, Summer 2005. 35 [2012] NSWCA 333. 36 At [73]. 37 At [84]. 38 At [83]. 39 At [127]. 40 *Bibby Financial Services Australia Pty Ltd v Sharma* [2014] NSWCA 37. 41 (1931) 45 CLR 359 at 377-8 (Dixon J) (authority for the proposition that a termination of a contract may be justified by reference to any ground that was valid at the time of termination even though it was not relied on at the time and even though the ground actually relied on is found to be without substance). 42 J W Carter, *Carter's Breach of Contract* (LexisNexis Butterworths 2011) at [10-08]. 43 *Bibby*, see note 40 above, at [126]. 44 R Wood, see note 34 above. 45 *Downer*, see note 35 above, at [69]. 46 R Wood, see note 34 above.

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