

Insight

on Employment & Benefits

Nil bonus awards and the forfeiture of deferred compensation

Bonus and incentive plans often form a very significant part of employees' overall remuneration, particularly in the banking and financial services sector, where bonuses often surpass basic salary. In the current economic climate, many employers have experienced a squeeze on bonus pools and, increasingly, have had to defend their bonus and incentives decisions.

In our December 2006 Insight, we discussed the decision in *Keen -v- Commerzbank AG*¹, which confirmed that the UK's Unfair Contract Terms Act² ("UCTA") does not apply to contracts of employment, and illustrated the courts' reluctance to interfere with the exercise of the discretions when making bonus decisions. The case of *Ridgway -v- JP Morgan Chase Bank National Association*³ has reinforced this decision, and seen the High Court uphold a nil bonus award.

The case concerned Daniel Ridgway, the Head of the Options Trading Desk at JP Morgan Chase Bank, who had been at the bank since December 1999, but who, following a year's sabbatical (beginning on 14 April 2003), tendered his resignation in June 2004.

As part of Mr Ridgway's remuneration package, he was regularly awarded significant annual bonuses in the form of cash and various kinds of deferred compensation, namely share options and restricted stock/share units ("RSUs").

The share options and RSUs were subject to terms under which they would be lost upon termination of employment, except in certain specified circumstances. At the end of 2000, JP Morgan merged with another bank to form JP Morgan Chase Bank (the "Bank"). After the merger, a rule was introduced into the Bank's deferred compensation plans, known as the "Rule of 45". It provided that those employees who left voluntarily would have their shares vest on the original terms of the award, provided that (i) the sum of their age and their service with JP Morgan equalled or exceeded 45 years, and (ii) they had at least five years of continuous service.

Mr Ridgway was concerned about how the Rule of 45 would affect him, given his age and service. He raised those concerns; although it was subsequently disputed by the Bank whether any assurance was given by the Bank to him about the application of the Rule of 45. In April 2003, Mr Ridgway went on a year's sabbatical, on terms recorded in a letter which provided (amongst other things) that:



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¹ [2006] EWCA Civ 1536.

² Although a detailed examination of UCTA is beyond this Insight, in short the Act imposes a statutory level of reasonableness as to terms in a contract – especially where one party is operating on the basis of the terms of its standard form contract and the other accepts these terms when 'dealing as a consumer'.

³ [2007] EWHC 1325 (QB).

1. he would continue to be eligible to be considered for a discretionary bonus in respect of his contribution to the Bank during the performance year;
2. there was no guarantee that Mr Ridgway would be able to return to his former job, or that a suitable alternative job would be available for him at the expiry of the sabbatical; and
3. the Bank would make every effort to find a suitable job for him upon his return

In January 2004 the Bank decided to award him a 'nil bonus' for the performance year 2003, and announced the decision in the usual manner (no challenge was made by Mr Ridgway to that decision, until his solicitors' letter before action in December 2004).

Upon Mr Ridgway's return from sabbatical, his former job was no longer available, and various discussions took place regarding a suitable alternative. These discussions proved unfruitful. In a letter of June 2004, the Bank took the position that its offer of a position as a proprietary trader was a suitable alternative and that, if Mr Ridgway failed to accept it, the Bank would treat such conduct as a fundamental breach of contract on his part and terminate his employment. Mr Ridgway's response was to give notice in the same month, terminating his employment.

He then issued proceedings seeking:

1. damages for breach of contract in relation to his deferred compensation (both share options and RSUs) that the Bank had treated as forfeited upon and as a result of the termination of his contract of employment (the "**Deferred Compensation Claim**"); and
2. damages for breach of contract in respect of the Bank's decision to award him a nil bonus for the performance year 2003 (the "**Nil Bonus Claim**").

Nil Bonus Claim

Generally (under English law), it will be harder for an employer to justify a 'nil bonus' than to justify at least some level of bonus. The employer does not have to show that it acted reasonably but it

must, as an implied term under English law, demonstrate that it undertook a meaningful and rational analysis of the employee's entitlement.

In *Ridgway*, the general system operated by the Bank when awarding bonuses was as follows:

A bonus pool for the relevant performance year would be allocated to a particular group of employees. Each employee eligible for consideration would provide a self-assessment and there would be a comprehensive review in which peers, managers and those junior to the individual would comment on his performance over the year in question. In addition, meetings might be held at which the senior management in charge of the particular bonus pool would receive and discuss relevant information.

In the Nil Bonus Claim, Mr Ridgway relied on the contractual provisions contained in the letter setting out the terms of his sabbatical and, accordingly, that it was agreed:

1. he was contractually entitled to be considered for a (discretionary) bonus award in respect of his contribution to the Bank in the performance year 2003;
2. the Bank had a discretion whether to award him any such bonus; and
3. the Bank was legally obliged not to act perversely or irrationally in the exercise of its discretion.

In light of the decision in *Keen*, the court stressed that "*the task of proving irrationality or perversity in the exercise of the Bank's discretion to award a bonus is a daunting one*". On the facts, the court found that the decision that Mr Ridgway should receive a 'nil bonus' had been taken on the joint recommendation of Mr Ridgway's line manager at the time and the Co-Head of the Bank's Rate Markets Trading for Europe, following a series of meetings between them in which they discussed Mr Ridgway's circumstances. The court rejected the suggestion that a 'nil bonus' was recommended simply because Mr Ridgway had been on sabbatical for much of 2003 and the court was satisfied

that the decision-makers had expressly considered what they believed to be the material factors relating to Mr Ridgway. The material factors considered included:

- he only worked for about three months of the 2003 financial year;
- his trading figures and profit and losses for the period he had traded during 2003 indicated that he was clearly making a loss;
- he was the only person on the options desk to have made an overall loss during 2003 (around \$2.3m);
- he did not actively manage his team and his add-on contribution was very limited; and
- there were no other special factors in 2003 that the Bank felt deserved recognition beyond Mr Ridgway's own financial performance.

In reaching its conclusion, the court noted that Mr Ridgway himself did not question the fairness, rationality or reasonableness of the decision, either at the time it was communicated to him in early 2004 or during the significant period of correspondence between the parties at the end of his sabbatical. As a result, the court was satisfied that the Bank had been entitled to reach the conclusion it did, and the decision to award a nil bonus was neither irrational nor perverse.

The general lesson to be learnt was employers should consequently be mindful of the need to demonstrate a transparent and fair process when determining levels of bonus.

Deferred Compensation Claim

One of the key terms in relation to the award of his share options was that in the event that Mr Ridgway's employment came to an end, any outstanding share options and any unvested RSUs would be forfeited immediately. However, this forfeiture rule was subject to specified exceptions.

Job elimination

Mr Ridgway claimed the circumstances of his termination came under one of

the specified exceptions, namely that if an “*involuntary*” termination of the job occurred as a result of “*job elimination*” then all outstanding options would become exercisable for a period of two years from the date of termination, and any unvested RSUs would (subject to Mr Ridgway executing a release) vest at the date of termination.

The Bank argued that under the terms of the deferred compensation agreement, the definition of “*job elimination*” was to be determined by the Director of Human Resources “*in his sole discretion*”; and that at no material time was it proposed to downsize the options desk nor was its workload reduced. Moreover, the alternative role as a proprietary trader which the Bank had offered Mr Ridgway was a suitable alternative job. The Bank claimed that there was scope for Mr Ridgway to hire a team and increase his role and that his reporting line, salary structure, terms and conditions would have been unchanged. The court took the view that it was clear that the termination was not by reason of job elimination, and in fact it was Mr Ridgway’s own notice of termination of his employment that resulted in his employment coming to an end.

UCTA

Under the option agreement, there was a further exception to the general rule if Mr Ridgway were to terminate his employment “*voluntarily*”. In these circumstances, any options that were exercisable immediately before his employment came to an end would not be forfeited, but would remain exercisable for a period of two years from the date of termination. This was on the condition that Mr Ridgway executed an agreement, which included a general release of the Bank and its subsidiaries and an undertaking by Mr Ridgway not to perform services for a competitor in any capacity during the period the options were outstanding.

Mr Ridgway argued that under UCTA, the Bank was not entitled to insist upon incorporating a term within a release agreement requiring him to forfeit his RSUs in order to be permitted to retain his options. However, the court disagreed and upheld the decision in *Keen*, which established that UCTA is not applicable to

employment related contracts (i.e. where the party accepting the terms is not dealing as a consumer). The terms of both the option agreement and release agreement were in fact terms of remuneration of certain employees and not standard terms of the business of banking. The Bank was not dealing with Mr Ridgway as part of its actual business – it did not (unlike, say, an employment agency) have a business of employing people. Of further significance was the fact that Mr Ridgway had expressed no concern at the prospect of waiving such a claim if he were to sign the release agreement that would have enabled him to retain his options.

Oral assurance

As part of his claim, Mr Ridgway also alleged that the Bank’s Head of Sales and Trading had given him an oral assurance that the Rule of 45 would not apply to him if he were to leave on good terms. However, the court dismissed this allegation, concluding that nothing was said that could have amounted to any exemption from, or waiver of, the Rule of 45. The court took the view that there was no sensible reason for the Bank’s Head of Sales and Trading to have given any such assurance to Mr Ridgway, particularly as he did not have the necessary authority to vary or waive any of the Bank’s rules with regard to deferred compensation. Furthermore, there was never any written record or note of any such assurance. The court emphasised that, as Vice President, it was not credible that Mr Ridgway was so naïve about commercial matters that he would have failed to commit a clear assurance of this importance to writing if such an assurance had been forthcoming. It also noted that, once again, Mr Ridgway did not raise the issue of the alleged assurance until his resignation letter.

Breach of trust and confidence

Mr Ridgway argued that the implied term of trust and confidence (which is implied into all employment agreements under English law) also implied a limit on the employer’s right to terminate the contract, where the effect of doing so would be to deprive the employee of a benefit. Mr Ridgway further claimed that the Bank undermined his position by bringing in a new Head of the Options Trading Desk.

Furthermore, he claimed that proprietary trading role offered involved a “step down” in responsibility and/or status.

However, the Bank maintained that the role offered was, in all respects, a suitable alternative job in an area in which Mr Ridgway had considerable trading experience and expertise. It also argued that the other possible positions discussed with Mr Ridgway would also have been suitable alternatives. However, these other possibilities were never progressed beyond the stage of suggestion because of Mr Ridgway’s unreasonable refusal even to consider them.

The court accepted the Bank’s evidence and emphasised:

- it was a term of the sabbatical letter that Mr Ridgway would not necessarily be able to return to his old job; and
- at all times the Bank had shown a desire for Mr Ridgway, a valued employee, to return after his sabbatical.

Therefore the court held that the Bank did not act in breach of the implied term of trust and confidence; the Bank was not forcing Mr Ridgway to take an alternative job that was not suitable and so Mr Ridgway did not have any proper basis for treating himself as having been constructively dismissed by the Bank.

Points to note....

This case is important in that it highlights the courts’ reluctance to interfere with the exercise of an employer’s discretion in bonuses. It confirms that it will be difficult for an employee to establish that an employer was irrational in exercising discretions in bonuses. Nonetheless, an employer must be alert to the risk of an employee succeeding in a claim for breach of contract if the employer does not exercise its discretions in a fair and transparent manner.

Furthermore, the case illustrates well that it is not uncommon for employees to argue that although the bonus plan was discretionary, their manager promised a certain amount would be paid. In many cases, such statements will not be binding, because there was no

intention on the part of the employer to create a contractually binding promise. However, even if this is the case, the statement may be used to support an argument that a subsequent award was irrational if it differs significantly from what was indicated previously. We would therefore recommend the inclusion of a statement that oral representations are not binding and that terms may only be varied in writing in the bonus plan or agreement. However, employers should also ensure that senior members of their staff:

- avoid making promises that cannot be kept;
- make notes of anything that has been said; and
- where indications have been given, ensure that there is a rational reason for departing from them.

In order to maintain the best possible position to defend such claims, employers should draft their bonus and incentive plans carefully, noting in particular that:

- the award of a bonus, level of a bonus pool, and bonus payable (if any) should be stated to be at the employer's sole and absolute discretion;
- there should be an express provision that participation in plan does not mean that any bonus or other award will be payable;
- the targets/criteria which will be taken into account when assessing the level of award (if any) should be clear to the participants; and
- the internal decision-making processes should be carefully documented to help demonstrate good faith and provide evidence that the discretion was not exercised in a discriminatory, irrational or perverse manner.

If you have any questions arising as a result of this Insight please do not hesitate to contact Oliver Brettle or your usual White & Case contact shown opposite.

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