

LINE MANAGER GUIDE – DISCRETIONARY BONUSES

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1. INTRODUCTION

Discretionary bonuses are a useful reward system as they can help to motivate and maintain staff. However, as court decisions over the last few years have spelled out only too clearly, the use of the word ‘discretionary’ is misleading.

At the simplest level, some contracts of employment contain a clause providing for the payment of a bonus ‘entirely at the discretion’ of the employer. Others contain a separate set of bonus scheme rules defining much more precisely both the eligibility and the qualifying requirements for bonuses and the factors that will be taken into account in determining the exact level of bonus payable.

It is obviously preferable for an employer to have proper bonus scheme rules (i.e., a separate and detailed set of bonus scheme rules) if it wishes to limit the prospect of a contractual claim from a disgruntled employee for non-payment of a bonus.

2. ELIGIBILITY REQUIREMENTS

When drafting scheme rules, after specifying the scheme is entirely discretionary and non-contractual, the starting point is for the employer to consider which employees will be eligible and how the bonus scheme will operate in practice. Factors to consider include the following:

- What will the frequency of payment of the bonus and the bonus payment date(s) be? Noting if the bonus is to be paid annually or quarterly, what the bonus year or the relevant quarters will be must be decided.
- Is the bonus scheme to apply to only certain employees? If so, these will need to be defined (i.e., by department, scale, etc).
- Does an employee need to be employed (or need to have already served a period of qualifying service) on the first day of a bonus period in order to be eligible to receive the bonus or will those employees who commence employment part way through a bonus period receive a pro rata amount?
- Does an employee still need to be in employment on the bonus payment date in order to qualify? If so, employees who are no longer in employment for whatever reason on the bonus payment date will need to be excluded.
- If an employee is under notice of termination of employment (whether given by the employer or employee) on the bonus payment date, will they still qualify for a bonus? If

not, the rules will need to clarify that no bonus will be payable where employees are under notice of termination of employment on the bonus payment date.

- What are the maximum parameters for the amount of the bonus? This could be a set amount or a percentage of basic salary.
- Are bonuses to be paid to employees on maternity leave, long-term sick leave or career breaks? The rules could provide that an employee must be in active employment at the bonus payment date. Alternatively, they could provide that only the period of employment in the bonus year that was active employment will be taken into account in calculating the bonus payable. That said, an employer needs to have regard to the risk of a sex, pregnancy and maternity, or disability discrimination claim (or an equal pay claim if the bonus scheme is contractual and not discretionary)

Whatever terms it decides on, the employer should reserve the right to withdraw the discretionary bonus scheme or change its rules, including the amount of bonus payable, at any time and from time to time. And, once drafted, the rules should be reviewed on a regular basis to make sure that they work in practice.

3. KEY PERFORMANCE CONDITIONS

Having set the eligibility requirements, the employer must consider what factors will count in the determination of the bonus. It might be based on individual performance, on overall performance of a department, or on both.

Where individual performance is to be assessed, the key performance conditions will need to be set out clearly. These might be targets or standards that need to be attained under headings such as attendance record, timekeeping record, (sales) targets and effective management duties. Bonuses are usually intended to reward good performance, and this should always be borne in mind as an employer will not want to find itself stuck with having to reward poor performers through having given inadequate thought to the key performance conditions.

Where the bonus is dependent on overall department and/or company performance, the performance levels that need to be achieved must be defined. The bonus might, for example, be dependent on the company's turnover or profitability.

Where the bonus is partly dependent on individual performance and overall department and/or company performance, thought will need to be given to how this will work in practice.

For example, if an employee performs well and meets all of their targets, but the company has a bad trading year, will the bonus or part of it still be payable - or will individual and department and/or company performance conditions need to be met in order for the bonus to be paid?

Finally, it is worth including a clause to the effect that no bonus payment awarded to an employee in any bonus payment period will act as a precedent for future bonus periods because the bonus is not guaranteed in any way.

This may help to counter an argument from an employee that they had a contractual expectation of a bonus or a particular level of bonus because they received one in the past.

4. MATERNITY & LONG-TERM SICK LEAVE

During both ordinary and additional maternity leave, the employee has a right to benefit from the terms and conditions of employment that would have been applicable if they had not been on maternity leave, with the exception of “remuneration”.

A bonus will be remuneration if it can be correctly classed both as a contractual payment and as deferred pay for work done. This is most likely to be the case if it is entirely dependent on individual performance or attendance and is not connected to staff retention/loyalty.

If the bonus is remuneration, then the weeks of maternity leave can probably be excluded from the bonus calculation, with the exception of the two-week compulsory maternity leave period that all working mothers are required by law to take immediately after birth.

This means that the bonus could be paid pro rata for the period of work done prior to the start of maternity leave (adding in the compulsory maternity leave period) and the period after the end of maternity leave.

While this is the position in relation to contractual bonus schemes the situation with regard discretionary bonus schemes is not as clear. This is because, arguably, such bonuses cannot be considered as arising from the contract of employment and are not remuneration.

If the bonus is not remuneration because it is not a contractual payment and not classed as deferred pay for work done during the bonus period, the bonus will be payable in full for the maternity leave period.

This would probably be the case if the bonus is connected to staff retention/loyalty and, although still unclear, could also apply in relation to discretionary bonus schemes.

If an employee is excluded from consideration for a discretionary bonus altogether because they are absent on maternity leave on the bonus payment date, this is likely to amount to pregnancy and maternity discrimination on the part of the employer because the absence is pregnancy related. The employer should therefore carry out a pro rata calculation so that the employee receives a part of the bonus due.

If an employee is on long-term sick leave, the employer will need to consider whether the weeks spent on sick leave are to be excluded when calculating the bonus. Where the employee is disabled under the Equality Act 2010, the employer will need to be aware of the risk of a claim for discrimination arising from disability. As it is likely that excluding disability-related absence would amount to unfavourable treatment because of something arising in consequence of the employee’s disability, it will be unlawful unless the employer can show that it is justified, (i.e., that it is a proportionate means of achieving a legitimate aim.)

5. MANGING THE BONUS SCHEME

On the first day of the bonus period, the employer should circulate the rules of the bonus scheme to the relevant employees.

That way, there should be no misunderstanding about the conditions for payment. Likewise, if a bonus scheme based on individual performance is to be withdrawn, it is incumbent on the employer to make its intention clear in advance of the work being done by the employees.

This **will** necessarily involve it notifying the employees of the scheme's withdrawal in advance of the start of what would have been the bonus period.

During the course of a bonus period, if an employee is not on target to achieve the maximum level of bonus assessed by reference to individual performance, the employee needs to be made aware of this on an ongoing basis so that they have adequate opportunity to try and improve performance levels and so potentially increase the amount of bonus received.

Notes should be kept of any discussions of this nature with the employee.

6. EXERCISING DISCRETION

Although a bonus scheme may have been clearly expressed to be discretionary, the employer's exercise of discretion in relation to the scheme is not unfettered.

There is an implied obligation that an employer must exercise its discretion in a way that is fair and reasonable and not irrational, capricious, arbitrary or perverse.

Discretion has to be exercised rationally and in good faith. The employer will be in breach of contract if it exercises discretion in a way that no reasonable employer would have done.

It is possible that a court may go so far as to hold that the payment of a discretionary bonus has in fact become a contractual benefit. This could be the case if it finds that the payment of the bonus is part and parcel of the employer's remuneration structure, because of the high amount of the bonus when compared to basic salary; where the bonus has always been paid on a regular basis so that employees have come to expect to receive it; or where the bonus scheme is not specified to be non-contractual.

In a case where a discretionary bonus has hardened into a contractual entitlement, non-payment of the bonus would result in a breach of the employee's contract, enabling the employee to issue a claim for breach of contract in the county court or High Court, or a claim for unlawful deduction from wages in the employment tribunal.

Where a bonus scheme is still discretionary, once an employee can show entitlement to a discretionary bonus, because the employer has exercised its discretion and declared it as payable, it becomes a 'wage' properly payable under the rules on unlawful deductions from wages. This means that, should the employer then fail to pay the bonus, the employee can issue employment tribunal proceedings alleging that the employer has made an unlawful deduction from wages.

Once a bonus has been declared by the employer, it cannot be withdrawn unilaterally.