

Discretionary Payment Clauses Revisited

Introduction

Just in time for the financial crisis, which is currently shaking up not only the banking world, the Federal Labor Court (*BAG*) has once again chimed in, this time with a groundbreaking decision on discretionary payment clauses. The decision addresses the lawfulness of discretionary payment clauses in the context of bonuses, such as Christmas bonuses or anniversary bonuses. Ultimately, the decision however also impacts the payment of performance bonuses. The recent decision of the Federal Labor Court may constrain the flexible handling of such bonuses at a time when flexibility is particularly desirable for employers and -- in some cases -- even indispensable.

Decision of the Federal Labor Court dated July 30, 2008 (10 AZR 606/07)

In that case, the employer had paid a Christmas bonus over a time period of 11 years, but fails to pay Christmas bonus in the year 2004. The employment agreement provided as follows:

"The employee shall receive a Christmas bonus in the amount of one gross salary payment. The employee has no legal right to payment of a Christmas bonus. Any payment of a Christmas bonus is discretionary on the part of the employer and is revocable at any time."

In the view of the Federal Labor Court, this discretionary payment clause was invalid. As a result, the employee was entitled to payment of the Christmas bonus in question. The Federal Labor Court offered the following rationale for this outcome:

- The clause is contradictory and thus unclear and ambiguous, because the first part of clause provides for a right to payment of a Christmas bonus, while the second part excludes such a right. Only if a discretionary payment clause clearly and unambiguously excludes any right of the employee to payment of a bonus, does the employer have no obligation to make such a payment and does the employee have no claims against the employer.
- Another aspect of the decision, however, that is just as important is that the Federal Labor Court now recognizes discretionary payment clauses only for bonuses. In contrast, a discretionary payment clause is no longer a valid option for salary components that are paid on a regular basis.

Definition of bonus

The Federal Labor Court however left unanswered the question of exactly what constitutes a bonus, stating that merely designating a payment as a bonus is insufficient. What matters rather, according to the court, is whether the payment is made in addition to regular salary payments. This requirement, the Federal Labor Court held, is generally met if payments are made only on certain occasions or only once a year. One example cited by the Federal Labor Court in this connection is a Christmas bonus.

The Federal Labor Court has now indicated that -- contrary to the standards applicable in the past -- it will in the future be harmless if a payment is made exclusively for services previously rendered. This means that cut-off clauses and repayment clause will no longer be necessary to express that a bonus is paid at least in part to reward the employee's loyalty to the company; only in these cases was a discretionary payment clause an option in the past.

Although it is hardly possible -- as the Federal Labor Court itself concedes -- to draw a distinction between regular payments and bonus payments that has general validity, a discretionary payment clause should be lawful not only for Christmas and anniversary bonuses, but also for additional vacation bonuses and, in our opinion, generally also for performance bonuses (but see below). In contrast, a discretionary payment clause may not be used for extra pay or benefits that are paid on a regular basis, or for commissions that are payable on a monthly or quarterly basis. The same also applies if the employer makes a company car available to the employee.

Target agreements and bonuses

In the view of the Federal Labor Court, a discretionary payment clause is also invalid if payments are specifically intended to control the conduct of the employee and to influence his performance. The idea here is that in such cases the employee may reasonably assume that he will be entitled to a bonus provided that the requirements for payment of a bonus are fulfilled. This limitation primarily affects bonuses paid on the basis of detailed target agreements.

Practical recommendation

As we previously recommended in Client Newsletter 3/07, discretionary payment clauses for regular salary components should be replaced by revocation and set-off clause. Such clauses, too, are however subject to certain limitations.

When bonuses are granted, the first priority is to ensure that the agreement only holds out the prospect of a bonus payment. Phraseology such as "will receive" or "will participate" should in the future be avoided under all circumstances. The same applies to a hybrid revocation/discretionary payment clause.

In the future, special caution will also be warranted when agreeing on performance targets. If a discretionary payment clause is invalid, the employee may under certain circumstances be able to sue the employer for payment of the bonus, while the employer would have no means of reducing or completely canceling the bonus.

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