News about Bonuses and the Interaction of Employment Contracts and Collective Sources of Law

INTRODUCTION

It is not uncommon for employee bonus plans to be provided for by a works agreement with the works council. The advantage, for the employer, of providing for bonuses at the collective level is that it is much easier to make changes to a works agreement in cooperation with the works council and, most importantly, that such changes will affect at the same time all employees who fall within the scope of to the works agreement.

Whether as part of a works agreement or employment agreement, bonus provisions often stipulate cut-off clauses according to which the accrual of bonus claims is conditional upon the existence of an employment agreement or – if a stricter standard applies – an employment agreement not under notice at the time the bonus is paid.

FACTS OF THE DECISION DATED JUNE 7, 2011, CASE NO. 1 AZR 807/09

In a recent case the Federal Labor Court (*BAG*) reviewed a collective bonus scheme, i.e., a bonus system governed by a works agreement, which also included a cut-off clause according to which a bonus was only payable if the employment relationship was not under notice at payday unless the termination rooted in business-related reasons. As is common practice, bonuses under the scheme were based not only on the personal performance of each employee, but also on the earnings of the company.

The plaintiff was an employee who had left the employment of the company before the end of a calendar year and was seeking – despite the cut-off clause stipulated otherwise – a prorated bonus for the year in which her employment had ended.

One special feature of the rather complex situation under review by the court was that the employment contract of the employee not only made general reference to the applicability of works agreements, but also included general terms and conditions for bonuses that were otherwise governed by the works agreement, including a clause stipulating the bonus to be discretionary.

RATIONALE OF THE DECISION DATED JUNE 7, 2011

In its decision dated June 7, 2011, the Federal Labor Court started out by noting that a reference in employment contracts to a works agreement is not only declaratory in character, if the employment agreement also includes additional provisions for the bonus that is otherwise governed by the works agreement and if such provisions go beyond those of the works agreement. This can only be interpreted to mean that an employee has a claim for payment of a bonus not only on the basis of the works agreement, but also has a parallel – for the most part identical – claim under the employment agreement. For example, if the employer and works council at some point agreed to terminate without replacement a works agreement regarding bonuses, an employee would have a continued claim for payment of a bonus, namely on the (sole) basis of his employment agreement.

In addition, the Federal Labor Court decided with respect to the works agreement at issue that a bonus that is conditional upon the personal performance of the employee and the financial situation of the company represents performance-based pay, which due to its nature may not be made conditional upon the existence of an employment agreement not under notice on the date of payment. Such a condition would amount to an unlawful interference with the contractual mutuality of consideration, as the employer could otherwise retroactively deprive the employee of a claim for compensation after the employee has already rendered performance. For this reason, the Court held, the cut-off clause – even though the clause made a distinction between a termination for business reasons and a termination for reasons solely attributable to the sphere of the employee – did not meet the standard of law and reasonableness applicable to works agreements (§ 75 of the German Works Constitution Act – *BetrVG*).

In its decision the Federal Labor Court also clarified that the claim for a performance- based bonus in that case accrued on a *pro rata* basis at the end of each month of employment and that the employee was therefore entitled to payment of a bonus despite the fact that her employment had ended prior to the end of a calendar year. This was said to apply at least in cases where the bonus involves compensation in a relationship of direct mutuality and where – as was in the case at hand, and is quite common among variable compensation schemes in general – the works agreement provides for prorated payment, for example in cases in which an employee enters the employment of the company after the beginning of a calendar year.

OUTLOOK AND PRACTICAL RECOMMENDATIONS

The decision of the Federal Labor Court dated June 7, 2011 is of far-reaching importance, not only in terms of the handling and structuring of works agreements on bonuses, but also, and in particular, in terms of the structuring of employment contracts.

If an employment contract shall contain a reference to works agreements, the employer should make absolutely sure that the provision in the employment contract is limited to a

general, declaratory reference to all works agreements applicable at the employer's company (as amended from time to time) in future. Under no circumstances should works agreements be supplemented by collateral provisions in the employment contract. We urgently recommend that employers review their standard employment contracts.

In our opinion, exactly the same must apply to references in employment contracts to collective bargaining agreements, if the employment relationship is directly subject to such collective bargaining agreements. If the employment contract modifies or amends the applicable collective bargaining agreement in such a case, the employer must once again expect that the employee will have a claim not only directly under the collective bargaining agreement, but will also have a parallel claim under the employment agreement. These claims are not necessarily identical. Especially in the rare case where a collective bargaining agreement is modified so as to be less favorable to the employees, it is particularly painful for the employer if the new terms cannot be enforced against an employee due to contrary provisions in the employee's employment contract.

Not least, the decision of the Federal Labor Court also has a major impact on bonus clauses in employment agreements. For we assume that just as is the case for cut-off clauses in works agreements, cut-off clauses in employment contracts that are intended to prevent employees from receiving a prorated bonus if they enter or leave the employment of the company in the middle of the year are not necessarily valid anymore. The reason for this assumption is that the law and reasonableness standard applicable to the review of works agreements (§ 75 of the German Works Constitution Act) is much more liberal than the strict standard of review applicable to general terms and conditions included in standard employment contracts (§§ 305 et seq. of the German Civil Code – BGB). Hence we would not be surprised if the Federal Labor Court's division reviewing cases involving bonus payments governed by employment contracts, at the next opportunity applied the aforementioned principles also to standard employment contracts and bonus regimes that are in the sole discretion of the employer.

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