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"Employment Law in the High Court"
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BENEFITS: BONUSES, SHARE OPTIONS AND INCENTIVE SCHEMES

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A. Introduction

1. Disputes about employee benefits are at the core of employment litigation in the High Court because benefits are often where the money is. The traditional city remuneration system of a comparatively small basic salary, enhanced by a substantial bonus means that whether a bonus is due is often the most important issue between parties to High Court employment litigation. In executive terminations, the status of share options is often equally important. A PHI dispute can be of great financial importance to the parties, even where the employee is not a high-earner. The sums involved in employee benefits disputes often make the potential rewards (and risks) of High Court litigation worthwhile.

2. This paper attempts to cover the latest developments in these areas, as well as including some stargazing about where the next developments will be:

a) Bonuses: Where are we now on discretionary bonuses? What kind of irrationality test are the Courts applying? Where is the law going? What can employers do to minimise the risk of claims? Do employees have any choice but to bring bonus claims in the High Court? Is the High Court the right forum for bonus disputes?

b) PHI: What are the recent cases on private health insurance? What are the key dangers for employers and how can they be limited?

c) Share options: What are the latest cases? What can be done to minimise the risk of claims?

d) Misconduct and employment benefits: When can benefits be withheld for misconduct? Can a benefit be recovered if misconduct is later found? Can equitable remedies be deployed to assist an employer?

B. Bonuses

3. There have been important developments in recent years in the law relating to the treatment of bonuses. In particular, the Courts have identified a principle of law that discretionary bonuses must be dealt with on a rational basis by the employer. This development has been achieved by the implication of a reasonableness standard into the bonus provision. Public law standards of fair play are being incrementally applied to the contract of employment. By the use of implied terms and the idea of constructive dismissal, the Courts are imposing new obligations on employers. As in public law, there is now no such thing in a contract of employment as an unfettered or absolute discretion. Nor can an employer simply say that the employee has suffered no damage because the bonus was discretionary.

Discretionary Bonuses

4. In the early cases, various different tests were stated. In *White v Reflecting Roadstuds* [1991] IRLR 331, the EAT held that a discretion must be exercised on reasonable and sufficient grounds. This is potentially a very wide test, giving the Courts an extensive right of intervention based on the Court's view of what was reasonable in all the circumstances. In *Clark v BET Plc* [1997] IRLR 348, the test was stated more narrowly – being limited to situations where the employer acted capriciously. Capriciousness carries with it notions of bad faith and arbitrariness, a high test for an employee to meet.

5. As is well known, in *Clark v Nomura International plc* [2000] IRLR 766 Burton J adopted a middle course that has since been accepted without question in the High Court and the Court of Appeal. Burton J held that the "right test is one of irrationality or perversity… ie. that no reasonable employer would have exercised his discretion in this way" [40]. The link to the public law rationality test in *APPH v Wednesbury Corporation* [1948] 1 KB 223 was expressly recognised by Burton J. The same test is used by Employment Tribunals when assessing the fairness of a dismissal. Under this approach, "what the court does is thus not to substitute its own view, but to ask the question whether any reasonable employer could have come to such a conclusion" [40].

6. After *Clark* came *Mallone v BPB Industries plc* [2002] IRLR 452 (CA). In this case, Mr Mallone's vested share options were cancelled on his dismissal. The options were cancelled by the directors of BPB pursuant to an "absolute discretion" in the scheme rules, despite the options having vested and been a reward for *past* performance. The High Court found this to be improper and unsurprisingly, the Court of Appeal dismissed BPB's appeal. Rix LJ held that Burton J's test in *Clark* was the correct one. The Court is permitted to intervene in a bonus decision on grounds of irrationality. Bad faith, capriciousness or improper intent is not required [39]. Rix LJ also made some more general comments about share option schemes, perhaps suggesting that beneficiaries under these schemes should be treated more generously than employees claiming a discretionary bonus:

> [There is no] valid reason for treating the whole scheme as a sort of mirage: whereby the executive is welcomed as a participant, encouraged to perform well in return for reward, granted options in recognition of his good performance, led on to further acts of good performance and loyalty, only to learn at the end of his possibly many years of employment, when perhaps the tide has turned and his powers are waning, that his options, matured and vested as they may have become, are removed from him without explanation [45].

7. *Clark* was again applied in the long-running litigation between Steven Horkulak and Cantor Fitzgerald (*Horkulak v Cantor Fitzgerald Interantional* [2004] EWCA Civ 1287 and [2003] EWHC 1918 (QB)). Newman J held that Mr Horkulak was constructively dismissed as a result of ill-treatment by his boss, the President and CEO. However, as the Court of Appeal delicately put it, the case was "somewhat complicated" by the fact that, throughout his employment, the Mr Horkulak was "a heavy drinker. He was also a user of cocaine" [6]. Nevertheless, permission to appeal against the findings on liability was refused. The appeal proceeded on quantum issues only and some quantum issues (especially mitigation) were referred back to Newman J for reconsideration. The Court of Appeal confirmed that *Lavarack v Woods of Colchester* [1967] 1 QB 278 has little application to discretionary bonus cases. Damages are calculated on the basis of analysing what a proper and rational bonus would have been.

8. The most recent city discretionary bonus case is the decision of Langley J, sitting in the Commercial Court in *Kennedy v Dresdner Kleinwort Wasserstein* [2004] EWHC 1103 (Comm). In this case, there was a surprising measure of agreement between the parties as to the relevant principles and how they should be applied. In particular, DKW accepted that if, as Mr Kennedy alleged, he had earned $17 million for DKW in the bonus year, he was entitled to a substantial discretionary bonus. DKW defended the case entirely on its factual merits of how much money Mr Kennedy earned for the business. This measure of common ground shows that claims for discretionary bonuses are moving from being a novel legal area, to a more ordinary commercial dispute. Parties are focusing on the actual reasons for refusing a bonus, not arguing about the legal test. Langley J carefully analysed the many complex trades carried out by Mr Kennedy and concluded Mr Kennedy had vastly overstated the profits made and his contribution to them. The claim failed.

9. The principles seem to be as follows:

a) Employers should prepare a carefully drafted scheme identifying the factors that will be taken into account when making a bonus decision. If the "longevity" of the employee will be taken into account, the scheme should expressly say so.

b) An employer should think carefully before refusing a "discretionary" bonus to an employee.

c) The employer should carefully consider all of the relevant factors, especially the performance of the employee, before making a decision. Reasons should be formulated. Consultation with the employee would be a prudent step. No one factor should be given excessive weight.

d) Nil bonuses are particularly hard to defend. The employer must take into account the fact that there are often strong reasons in favour of awarding a bonus. A lowered bonus, backed up by reasons, is much more likely to survive a

challenge. A good analogy is with exclusion and limitation clauses. A blanket exclusion clause is often difficult to justify, but a clause limiting liability under a contract to a sensible amount is often justifiable.

e) In a case where the discretionary scheme is expressly or impliedly based around the individual performance of the employee, the lack of any need to incentivise the employee for the future is not a relevant consideration.

f) For the Court to intervene, the decision must be irrational, in the sense that no reasonable employer could have reached it. An honest employer can still act irrationally. However, bad faith, arbitrariness or capriciousness are all very strong indicators of irrationality.

10. The dangers of a poorly drafted scheme are well illustrated by the recent decision of the Court of Appeal in *Brand v Compro Computer Services Limited* [2005] IRLR 196. Mr Brand was a sales consultant for Compro, a recruitment consultancy. He was paid by a combination of a basic salary and a contractual formula bonus scheme. He was made redundant and claimed bonus earned, but not received on his dismissal. Compro relied on a term of the bonus scheme that "*the plan assumes that you remain in full-time employment with Compro at all times in order to qualify for the commission payments*". The Court of Appeal held (reversing the ET and the EAT) that this clause did not cancel Mr Brand's right to payment for bonus earned on sales but not yet paid, even though he was not longer "*in full-time employment with Compro at all times*". The Court of Appeal held that it "*would have needed clearer words to override the entitlement to the reward of commission on sales achieved before the employment ended*" [36]. Further, the Court of Appeal was reluctant to countenance a situation that would allow "*the well-advised employer… always seek to terminate the contract of employment shortly before the commission payment date at the end of the month*" [37].

11. Public law has been the inspiration for the development of the law relating to discretionary bonuses. To work out the future limits of the principles set out in *Clark* and

Mallone, it is useful to look at how public law has expanded beyond *Wednesbury* and how it is likely to continue to expand in the next few years. The current position in public law is that few cases are decided on pure *Wednesbury* principles. The irrationality test is just one type of abuse of power that the Courts will intervene to stop. More sophisticated tests are regularly articulated by the Courts. In particular, the Court will look to see if all the relevant factors were clearly taken into account and that all the irrelevant factors were discarded from consideration (*R v SSTI, ex p Lohnro* [1989] 1 WLR 525). Are like cases treated alike (*R (Kelsall) v SSEFRA* [2003] EWHC Admin 459, Stanley Burnton J)? Is the purpose of the scheme being furthered or frustrated by the approach of the decision maker (*Padfield v MAFF* [1968] AC 997)?

12. These wider principles can already been seen influencing the decisions in *Clark* and *Mallone*. For example, in *Clark*, Burton J emphasised the purpose of the bonus scheme as being to reward individual performance. Comparisons were made with past bonuses, as part of a conclusion that a rational decision had not been reached. By looking at the wider principles applied in public law, it becomes easier to understand in what kind of bonus case the Court will intervene. Other cases already show wider public law principles being applied (without express reference) in an employment context. For example, in *Transco v O'Brien* [2002] IRLR 444 Pill LJ commented "to single out an employee on capricious grounds and refuse to offer him the same terms as are offered to the rest of the workforce is in my judgment a breach of the implied term of trust and confidence". A public lawyer would classify this statement as being an example of the developing common law principle of equality – treating like cases alike (*Arthur JS Hall and Co v Simons* [2000] 3 WLR 543 (HL), at 560, *per* Lord Hoffmann; *A v Secretary of State for the Home Department* [2004] UKHL 56 (HL), paragraph 46, *per* Lord Bingham of Cornhill).

13. For the future, the case law is likely to develop in a way that mirrors and perhaps even anticipates the development of public law. In the short-term, we are likely to see express recognition that a wide range of 'public law' grounds of challenge are available to employees when attacking a discretionary bonus decision. In practice, this is already the case. What is missing from the cases is a clear statement to this effect.

14. In the longer-term, it is likely that the test applied by the Court will shift towards the employee. As there are more cases, the Courts will become more confident in reviewing the decisions of employers. Also, it is widely recognised in the public law field that the *Wednesbury* test (adopted by Burton J in *Clark*) is outdated and restrictive. The preferred alternative is the more sophisticated principle of proportionality. The key difference is that the Court can interfere not only where a decision is irrational (in the sense of defying reason or something that no reasonable person could do) but also where the step taken is excessive or goes further than is appropriate or necessary. For example, in *International Transport Roth GmbH v SSHD* [2003] QB 728, automatic fixed penalties for unwitting lorry drivers who carried illegal immigrants were found to be disproportionate. It was not disputed that the measure had a legitimate aim, but the means chosen was too harsh and inflexible. Under a *Wednesbury* test, the claim would probably have failed. The relevance of a proportionality test to discretionary bonus cases is plain: employees would gain an additional argument.

15. At present, the principle of proportionality is only applied in public law cases where human rights or EU law issues are involved. In common law cases, *Wednesbury* still is the law. This fact has been subject to strong criticism by the Court of Appeal, but it remains the law, at least until the next *Wednesbury* case gets to the House of Lords (*R (Association of British Civilian Internees – Far East Region) v SSD* [2003] QB 1397). However, in practice, proportionality principles are already being applied under the guise of irrationality, both in public law (eg. *Watford Grammar School* [2003] EWHC 1480) and in employment cases (eg. *Mallone*, where Rix LJ obviously thought it very important that there was a complete *cancellation* of all the options, rather than a *reduction* by an appropriate percentage). In this developing area of law, employment law may lead the way, with public law to follow.

Forum Shopping

16. There are many kinds of bonus claim. Most are dealt with by the Employment Tribunals. Only a very few are litigated in the High Court. In many cases, there may be a choice as to whether the claim should be brought in the High Court or in the

Employment Tribunal and often the High Court will be wrong choice, especially for employees. The Employment Tribunal has extensive jurisdiction over many kinds of bonus claim. Litigators should always think carefully about the right forum. A mistake can be very costly.

17. Bonus claims have traditionally found their way into Employment Tribunal litigation in a variety of ways. Often a future bonus is claimed as part of the loss in an unfair dismissal claim, subject to the statutory cap. In city discrimination cases, the value of future bonuses is often a key part of the Tribunal's decision on remedies, and there is no cap. Claims for a past unpaid bonus can also be brought as a claim for breach of contract (subject to the cap of £25,000).

18. An often overlooked way of brining a bonus claim in an Employment Tribunal is to claim for unlawful deductions from wages. Section 13 of ERA 1996 provides that:

> (1) An employer shall not make a deduction from wages of a worker employed by him unless-
>
> > (a) the deduction is required or authorised to be made by virtue of a statutory provision or a relevant provision of the worker's contract, or
> >
> > (b) the worker has previously signified in writing his agreement or consent to the making of the deduction…
>
> (3) Where the total amount of wages paid on any occasion by an employer to a worker employed by him is less than the total amount of the wages properly payable by him to the worker on that occasion (after deductions), the amount of the deficiency shall be treated for the purposes of this Part as a deduction made by the employer from the worker's wages on that occasion.

"Wages" is defined in section 27 ERA 1996:

> (1) In this Part, "wages", in relation to a worker, means any sums payable to the worker in connection with his employment, including-
>
> > (a) any fee, bonus, commission, holiday pay or other emolument referable to his employment, whether payable under his contract or otherwise**.**

19. If a bonus claim can be brought as a claim for an unlawful deduction from wages in the Employment Tribunal there are potentially huge advantages for the Applicant:

a) Anti-set off provisions in section 25(1) ERA 1996:

> Where a tribunal has under section 24 ordered an employer to pay or repay to a worker any amount in respect of a deduction or payment falling within section 23(1)(a) to (d), the amount which the employer is entitled to recover (by whatever means) in respect of the matter in relation to which the deduction or payment was originally made or received shall be treated as reduced by that amount.

See *Potter v Hunt Contracts Ltd* [1992] IRLR 108, EAT ("… a sanction against unlawful deductions by employers…") and *Delaney v Staples* [1992] 1 AC 687 at [694f], HL ("This is a penal provision. If, for example, an employer made an unauthorised deduction from wages in respect of a valid cross-claim against the worker the industrial tribunal would be bound to order repayment of the deduction and the employer's cross-claim would for all purposes and in all courts be reduced by the amount improperly deducted").

b) Misconduct arguments kept out.

c) No need for a dismissal.

d) No cap on compensation.

e) Minimal costs risk.

f) No Part 36 regime.

g) Lower litigation costs.

h) Employment Tribunal fear factor.

20. Some kinds of bonus claims can certainly be brought as a claim for unlawful deductions. For example, if a contractual bonus payable under a set formula (x% of sales) is not paid, that is an unlawful deduction. If a guaranteed bonus is not paid, that is also an unlawful deduction.

21. But what about pure discretionary bonuses? *Clark* type claims for a "reasonable" bonus under a discretionary scheme are normally brought in the High Court for breach of contract. Breaches of contract claims in the Tribunal are often no good due to the cap on damages. Can such claims be brought in the Employment Tribunal as an unlawful deductions claim?

22. An unlawful deduction from wages claim only covers "wages properly payable" to the employee. Where the claim is for unliquidated damages for breach of contract, it is quite difficult to say there is any sum "properly payable" to the employee until the Court or Tribunal has given judgment and assessed damages.

23. Until then, all the employee has is a right of claim which may or may not be worth something, depending on the Court or Tribunal's assessment of damages. There is no ascertainable sum "properly payable" on a particular date. See *Delaney v Staples* [1992] 1 AC 687 at [696f-697a] per Lord Browne-Wilkinson. This type of claim must be brought in the High Court.

24. The recent decision of the EAT in *Farrell Matthews & Weir v Hansen* [2005] IRLR 160 (Nelson J, Mr D Jenkins, Mrs M McArthur) sets out the limits of a discretionary bonus claim framed as an unlawful deduction from wages. Ms Hansen was a salaried partner of a firm of solicitors. She was awarded a discretionary bonus for her past performance. The bonus was to be payable in 12 monthly instalments of £1,000. Prior to all the payments being made, she was constructively dismissed.

25. The EAT confirmed that "until the discretion is exercised in favour of granting a bonus, provided the discretion is exercised properly, no bonus is payable"[40]. So, if the bonus had not been assessed, a claim for unlawful deduction from wages would have failed.

26. But, the EAT held that once a bonus had been assessed and declared, it could not be withdrawn. The unlawful deductions claim was crystallised by the announcement. Therefore, if a discretionary bonus is awarded and then not paid on the due date, that is also an unlawful deduction, even if the discretionary bonus is non-contractual.

C. Private Health Insurance and Permanent Health Insurance ("PHI")

27. PHI is a valuable and very common contractual employment benefit. Like all kinds of insurance, PHI is of no value or interest until the employee becomes ill. When illness happens, the insurance can be of great value. Even low-paid employees may have very valuable claims. Several problems keep occurring, both in the context of PHI and other types of health benefits:

a) Differences between the terms of the insurance policy and the coverage promised by the contract of employment.

b) Coverage disputes. Is the employee's condition covered by the plan?

c) Termination. Can the employer terminate the employment of someone who would be eligible to receive benefits under the plan?

Differences In Terms

28. Normally, an employer will back-up its contractual commitment to PHI by taking out an insurance policy to cover most the liability. Problems occur when the terms of the insurance policy are different (or become different) from the terms of the contract of employment. For example, after a TUPE transfer, insurance arrangements may be

consolidated with a new insurer on different terms. The employee claims from the employer based on the terms of the contract of employment, but the insurer refuses to pay out based on the policy terms in the insurance contract. In these situations, should the employer foot the bill?

29. The answer depends on ordinary principles of construction. The Court will ask whether the terms of the insurance policy have been incorporated into the contract of employment, or whether the employer is offering benefits independently from the terms of any contract.

30. In cases where the contract of employment states the benefits provided, but makes no reference to the underlying insurance policy, the employer may well be bound by the promise of benefits. The employer's responsibility is to cover its potential liability with suitable insurance. If it fails to do so, the burden of payment falls on the employer. In contrast, if the contract of employment makes express reference to the policy, the insurers and their terms, then the terms of the policy will probably be incorporated (*Briscoe v Lubrizol* [2002] IRLR 607).

31. However, there are limits to this principle. The employer will not be able to escape liability by pointing to unusual and onerous terms in the policy, if those limitations and restrictions have not been made clear to the employee (*Villella v MFI Furniture Centres Ltd* [1999] IRLR 499). Again, this is an application of ordinary contractual principles – some clauses, as Denning LJ famously said, need to be printed in red ink with a red hand pointing to them to be effectively incorporated in the contract (*Spurling v Bradshaw* [1956] 1 WLR 461 at [466]). A prudent employer should make copies of the insurance policy available to employees when they join and whenever the policy is changed. A summary of the policy, identifying the key limitations and exclusions would also be a prudent step.

32. Also, an employer that erroneously states the coverage of the PHI policy as being narrower than it in fact is, will find it difficult to rely on its own mis-description to avoid

liability (*Briscoe*). Once again, this is an application of ordinary contractual principles. The Court will look at the full factual background to decide what the words used mean in their proper context. The insurance policy is an important part of the context. See, for example, *Mannai Limited v Eagle Star Assurance Company Limited* [1997] AC 749 and *West Bromwich Building Society v ICS* [1998] 1 WLR 896.

Coverage Disputes

33. The complexity of many PHI policies creates fertile ground for disputes as to whether a particular employee is covered for their particular condition. A common dispute has been meaning of "own occupation" and "any occupation" conditions in the insurance policy. Some Permanent Health Insurance policies will pay out if the employee is unable to carry out their own occupation (eg. if a lawyer was not fit to practice law, but fit to work as a shop assistant). Other policies have an "any occupation" test.

34. As might be expected, the Courts have sought to mitigate the potential severity of "any occupation" tests by construing them in favour of the employee. In *Walton v Airtours Plc* [2003] IRLR 161, an airline pilot developed ME and became unfit to fly, but was fit to work part-time in less demanding jobs as a part of a rehabilitation programme. The Court of Appeal held that "any occupation" meant regular work for a substantial or indefinite period, not temporary part-time irregular work.

35. The decision of the Court of Appeal in *Jowitt v Pioneer Technology* [2003] IRLR 411 adopts a similar approach. The policy wording (which was held to be incorporated) referred to an employee being "unable to work". Sedley LJ held that this was not to be construed literally, but meant, in the context, an ability to do continuous remunerative full-time work of a type which the employee could realistically be expected to do. This formula is likely to be widely adopted, but will require a judgment to be made as to what work it is realistic to expect an employee to do. Andrew Stafford QC has suggested that the duty is likely to be similar to the duty to mitigate losses. As he puts it, a former managing director might not be expected to clean lavatories, but a salesman might be expected to take a job as working as a sales assistant.

Dismissal

36. An employer that dismisses an ill employee will be most concerned about a potential claim under the Disability Discrimination Act 1995. However, there may be contractual limitations on dismissing an employee enjoying the benefits of PHI. The Courts have used the implied term of trust and confidence to fetter the employer's entitlement to terminate the employment of an employee who is ill and receiving, or about to be entitled to receive, benefits under an insurance policy. The cases have suggested that an employee, having become entitled under such a scheme, can only be dismissed for cause, for example for gross misconduct or in a genuine redundancy situation (*Aspden v Webbs Poultry* [1996] IRLR 521, where an implied term was incorporated despite an express term allowing termination for prolonged sickness, and also *Brompton v AOC International* [1997] IRLR 639).

37. However, these cases are now in some doubt following the decision of the Privy Council in *Reda v Flag Limited* [2002] IRLR 38. In *Reda* the Privy Council held that a dismissal to avoid the accrual of employment benefits was lawful in a case where there was an express power of termination without cause. *Aspden* was discussed and it was suggested that the express power to dismiss in *Aspden* was mistakenly retained in the contract after introduction of the sickness scheme. The correct way of approaching that case was said to be rectification, not the implication of a term preventing dismissal. Following this decision, employers may attempt to redraft contracts to give them express powers of termination. However, it seems likely that the Courts will continue to be keen to avoid seeing sick employees deprived of employment benefits. *Reda* is of great persuasive authority, but it does not bind the domestic courts. One way round the decision might be to construe narrowly any express right to dismiss without cause, thus avoiding the need for any implied terms. The general unwillingness of the Court of Appeal to adopt the harsh approach of *Reda* was recently shown in *Horkulak* at [49], albeit on a different point.

D. Share Options

38. High Court disputes about share options typically follow a similar course to bonus disputes. The same principles of law apply and employers should take similar steps to ensure that they act lawfully. In particular, schemes should be drafted so that employers have a wide discretion, but the relevant factors when determining distributions should be stated. If an employer wants a power to take away vested share options, this power must be clearly stated and exercised for proper reasons, bearing in mind that the employee is being deprived of an accrued property right. The employee should be informed of the case being made against him or her and have the opportunity to make representations.

39. In each distribution round the employer must clearly identify the factors which will be taken into account when determining entitlements. The whole process should be carefully documented, so that it can be shown that a fair and fully reasoned decision making process has taken place. Objective and measurable criteria should be applied.

E. Misconduct And Employee Benefits

40. Misconduct often forms the backcloth to a dispute about employee benefits. If employers are aware of misconduct, they are often unwilling to pay any bonus or permit the exercise of share options. For example, in *Clark v Nomura*, Nomura claimed that Mr Clark had committed misconduct and that this (in part) justified its decision not to award any bonus. Burton J found the allegations of misconduct to be exaggerated. In *Horkulak,* the defence was that the Claimant "simply… could not cope". Again, "the judge rejected this defence *in toto*" [6]. However, it is not in doubt that under a properly worded "discretionary" bonus scheme, it would be proper to reduce or refuse a bonus if an employee has committed serious misconduct in the bonus year.

41. However, problems arise when the misconduct is only discovered *after* the share options have been granted or the bonus level determined. The employee will wish to bring a claim to recover any amount which has been withheld, or be permitted to exercise share options. The employer is forced to find a legal justification for withholding payment.

Often, the simple solution for the employee is to frame his or her claim as being for unlawful deductions from wages in the Employment Tribunal. Once a sum has become properly payable under the contract on a particular date, it becomes very difficult for the employer to successfully defend the claim.

42. In High Court litigation, two approaches are becoming popular amongst employer's representatives. First, reliance on implied terms as a basis for refusing payment. Second, the use of equitable rights and remedies such as claims for breach of a fiduciary duty or payments under a mistake.

43. In *Tesco Stores Limited v Pook* [2003] EWHC 823 (Ch), Mr Pook had defrauded Tesco of large sums of money. When his conduct was discovered, he was dismissed. Just before his dismissal, and sensing that the writing was on the wall, Mr Pook attempted to exercise his vested and accrued share options. Tesco refused to permit Mr Pook to do so. Peter Smith J held that:

> I cannot conceive that the parties would have contemplated that somebody who had committed a serious breach of contract should never the less be entitled to exercise his proprietary rights. I therefore conclude that there was an implied term that the option would not be exercisable as long as the employee was in such breach of contract as would entitle the employer to terminate the contract of employment [52].

44. A term was therefore implied into the contract of employment preventing an employee from exercising any rights under the share option scheme if gross misconduct had been committed.

45. This decision, if correct, represents a boon for employers, particularly if the principle set out in the case can be extended to bonuses. However, there are grounds for caution. The decision may well not survive review by the Court of Appeal. In *Pook*, the Court has imposed a sweeping new implied term to the effect that if an employee has committed misconduct, an employer can withhold *accrued* benefits, due to the employee under the express terms of the contract of employment, pending a dismissal. This is at least

equivalent to suspension without pay, and possibly has far more severe financial consequences. The basis for this new implied term was said to be the principle in *Alghussein v Eton College* [1988] 1 WLR 587, HL (wrongdoers should not be able to take advantage of their own breach of contract). But that principle has no obvious application on the facts of *Pook*. The right being claimed (exercise of share options) had little to do with the misconduct committed. The misconduct committed by Mr Pook was unrelated to the share option scheme. In addition, Peter Smith J distinguished *Mallone* on the dubious ground that the Court of Appeal *Mallone* had not considered all of the relevant authorities. The important comments of Rix LJ about the need to protect accrued and vested proprietary rights were not expressly considered.

46. An alternative (and more convincing) way of achieving the same result would be to rely on a claim for breach of fiduciary duty. The argument runs as follows:

a) A director may have a duty to report the misconduct of others. Failure to do so is a breach of fiduciary duty (*Sybron Corporation v Rochem* [1984] Ch 112, CA).

b) This principle may well also extend to require directors and senior employees to report their own breaches of fiduciary duty, such as the taking of secret profits or bribes. However, following the decision of the Court of Appeal in *Item Software v Fassihi* [2004] EWCA Civ 1244, this point remains open for decision.

c) If the misconduct had been reported, the employee would have been immediately summarily dismissed without the right to exercise the share options or receive the bonus.

d) The employer's loss is therefore the value of the share options or bonus, which can be set off against the option/bonus claim, meaning that the employee is owed nothing.

47. Peter Smith J accepted this argument in *Tesco v Pook*, albeit *obiter,* but said that the duty to report misconduct only extended to breaches of fiduciary duty, not to mere breaches of contract. Fraudulent conduct, the diversion of a business opportunities or a failure to act in good faith is required. A breach of company policies and procedures will not be enough.

48. A further possibility is to try and reclaim bonuses and share options already paid out during a period in which gross misconduct had occurred. The employer's potential argument is that the payments were made under a mistake of fact because had the misconduct been known, the bonus or share options would not have been granted. These types of claim are increasingly commonly pleaded by creative employment lawyers, but have not to my knowledge yet been determined by the Courts. The real difficulty that an employer will have with this type of claim is that it is a defence that good consideration has been given for the payment. Unless the employer can show a total failure of consideration, it will probably be difficult to recover (see *Item Software* at first instance [2003] IRLR 769 at [108] and *Goff & Jones* paras. 4-042 – 4-046).

F. <u>Thanks</u>

49. I am very grateful to Victoria Windle for researching and helping to write the PHI and share options section of this paper. The errors are mine.