



Discretion

Inside



When 'absolute discretion' isn't
really discretion at all

Introduction

Beware when interpreting bonus and share plan rules - 'discretion' doesn't always mean discretion.

Why plans incorporate discretion

Companies operating incentive plans invariably incorporate maximum discretion to allow them to operate the arrangement as they think appropriate. For example:

- > if performance conditions are not met for reasons outside the control of participants, there should be discretion to allow full or partial vesting in any event
- > if an individual resigns to look after a sick spouse there should be discretion to treat him as a good leaver and allow him to keep his potential entitlements.

Is 'absolute' discretion really absolute?

Plan rules usually confer 'absolute' discretion on the company. However, it is becoming increasingly clear that courts are willing to intervene and overrule the exercise of discretion where they consider the exercise has been perverse, irrational or in bad faith.

The exercise of discretion must not be perverse and irrational

In *Clark v Nomura International* the company exercised its discretion and decided not to award a discretionary bonus to an employee who had been dismissed without cause and who had earned very significant amounts for the company. The court held that the exercise of discretion in this way was perverse and irrational and the employee was entitled to damages equal to the bonus he would have had if

he hadn't been dismissed.

Discretion must be exercised rationally as a reasonable employer would exercise it

In *Mallone v BPP Industries* the Court of Appeal held that the decision to reduce the proportion of options exercisable on termination of employment to nil where those options had been granted on the basis of past performance was irrational and one which no reasonable employer would have made. There was nothing in the circumstances of Mr Mallone's dismissal to warrant him being divested of those rights and he was entitled to damages accordingly.

Employees are entitled to a rational and bona fide exercise of discretion

In *Cantor Fitzgerald v Horkulak*, the court held that a senior employee who had been wrongfully dismissed was entitled to substantial damages in respect of his potential entitlement under a discretionary bonus scheme. Had he remained in employment he would have been entitled to a rational and bona fide exercise of discretion by his employer.

Discretion should be exercised in a bona fide manner and other factors should not be taken into account

In *McCarthy v McCarthy & Stone plc* the share option plan rules said the remuneration committee should take the extent to which performance conditions had been satisfied when exercising their discretion. As they had been satisfied in full, the committee was not acting in a bona fide manner when it exercised its 'absolute' discretion taking into account factors which had not affected the satisfaction of those conditions.

How we can help

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