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Incentive Compensation: When a Promise Becomes a Myth

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Money makes the world go round, a truth as reliable as death and taxes. Companies often lure and retain high performing employees, particularly executives, through promises of incentive compensation. Sophisticated employees seek certainty through a written agreement specifying their compensation package, while employers often insist on maintaining a large degree of discretion over performance-based compensation. This tension frequently results in a written agreement that contains language so broad that its enforceability becomes questionable.

Retention of Absolute Discretion Places Payment at Employer's Whim.

Suppose a well-credentialed executive commences work with a new employer after signing a contract that promises a salary plus a performance bonus based on objective criteria. Now suppose the executive exceeds expectations but the employer reneges on paying the full bonus. This is exactly the scenario posed in *Sathe v. Bank of N.Y.*, No. 89 CIV. 6810 LBS, 1990 WL 58862 (S.D.N.Y. May 2, 1990), where the court recognized the employer retained the right to deny a bonus even though the incentive plan included metrics identifying how a bonus would be calculated, because the plan included the following carveout language:

> All actions of this plan committee will be subject to the approval of the chairman. This plan can be amended, terminated or revoked at any time by the chairman. Nothing in this plan shall give rise to any special compensation or other sum under this plan unless and until any such amount shall have been paid to such individual, and prior to such payment the chairman shall have the power to revoke and nullify any and all steps previously taken towards making any award to any person.

Sathe, 1990 WL 58862, at *1. On its face, this language superseded the criteria purportedly used to calculate the bonus. Id. at 3-4. Consequently, the employer had an absolute right to adjust the executive's bonus to zero, and the exercise of this discretion did not run afoul

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of the implied obligation to act in good faith. Id.

Sathe is hardly an outlier. The New York Court of Appeals in *Namad v. Salomon*, 74 N.Y.2d 751, 753 (N.Y. 1989) affirmed the dismissal of an employee's claim for bonus compensation where the contract stated, "The amounts of other compensation and entitlements, if any, including regular bonuses, special bonuses and stock awards, shall be at the discretion of management[.]"

Other courts reached similar decisions. See *Valentine v. Carlisle Leasing Int'l Co.*, No. 97CV1406(RSP/GJD), 1998 WL 690877, at *4 (N.D.N.Y. Sept. 30, 1998) (dismissing claim for bonus because offer letter provided employer with discretion to determine whether and how much to pay); *Ferrari v. Keybank Nat. Ass'n*, No. 06-CV-6525, 2009 WL 35330, at *7-8 (W.D.N.Y. Jan. 5, 2009) (dismissing contract and implied duty of good faith and fair dealing claims where employer retained "sole and absolute" discretion to determine eligibility for incentive pay and amounts to be paid and retained right to modify incentive goals retroactively).

All of these plans used such terms as "sole discretion," "absolute discretion," "exclusive discretion," and "unlimited discretion," to free employers from contractual liability. Absent these "magic words," New York courts are reluctant to adopt an employer's contractual interpretation aimed at gutting an employee's bonus, *Lam v. Am. Exp. Co.*, 265 F. Supp. 2d 225, 237 (S.D.N.Y. 2003), and instead will enforce an incentive compensation provision if it offers a reasonable basis to calculate the amount owed, *O'Shea v. Bidcom*, No. 01 CIV.3855 WHP, 2002 WL 1610942, at *3 (S.D.N.Y. July 22, 2002).

In *Lam*, for example, an employer moved to dismiss a contract claim brought by a former employee by arguing that it properly exercised its discretion to lower the employee's compensation under the terms of a compensation deferment program. 265 F. Supp. 2d at 237. Although the contract included carve-out language stating "[t]here is no assurance that the illustrated performance or payouts in this exhibit will actually occur" and that a participants' rights are subject to the employer's right to modify the compensation program "to ensure alignment with business goals, objectives and measures," the court concluded that this language did not unambiguously confer the employer with absolute discretion. Id. at 237-38 (stating that plans did not authorize use of general managerial discretion to reduce, without explanation, individual incentive payments).

Additionally, in *O'Shea*, where the subject plan lacked the "magic words" conferring absolute discretion, the court held that the bonus at issue was earned when the participant reached the plan's specified goals. 2002 WL 1610942, at *4. Although the plan permitted the employer to adjust a participant's compensation at any time, the court ruled that the adjustment must be made subject to the plan's terms and conditions, not simply at the employer's whim. Id.

Likewise, the employer in *Culver v. Merrill Lynch & Co.*, No. 94 CIV. 8124 (LBS), 1995 WL 422203 (S.D.N.Y. July 17, 1995), lacked absolute discretion where the plan lacked the "magic words" even though it was financed through a single pool of cash and vested the company's division director and group manager with authority to determine the distribution of the pool. *Culver*, 1995 WL 422203, at *3.

In addition, in *Smith v. Railworks*, No. 10 CIV. 3980 NRB, 2011 WL 2016293 (S.D.N.Y. May 17, 2011), the court rejected an employer's argument that it retained absolute discretion by drawing a distinction between the "magic words" in a contract and the language in the plan at issue, which stated that the *distribution* of bonus money was subject to the approval of executive management." 2011 WL 2016293, at *4.

Right To Amend or Terminate 'At Any Time' May Render Contract Illusory.

Many courts outside New York have found that an employer's retention of the right to terminate a written agreement at any

time will render an apparent contract illusory and therefore unenforceable. See, e.g., *Barton v. Hewlett-Packard Co.*, No. CIV.A. 13-554, 2014 WL 6966986, at *5-6 (W.D. Pa. Dec. 9, 2014) (concluding employer's right to change or discontinue compensation policy at any time, with or without notice, reflected employer's intent not to be bound, rendering agreement unenforceable); *Hegel v. Brunswick*, No. 09-C-882, 2011 WL 1103825, at *5 (E.D. Wis. March 23, 2011) (finding term providing employer with broad authority to discontinue or cancel awards at any time rendered contract illusory); *Rogers v. Nat'l City*, No. 91103, 2009 WL 1622382, at *3 (Ohio Ct. App. June 11, 2009) ("Generally, a breach of contract claim for underpayment of a bonus or incentive compensation under an [Incentive Compensation Plan] cannot lie when the employer retains discretion to make such an award and even terminate the plan altogether."); *Rakos v. Skytel*, 954 F. Supp. 1234, 1237 (N.D. Ill. 1996) (concluding plan lacked promissory intent and was unenforceable because employer retained right to modify or cancel the plan at any time without prior notice).

The rationale behind these decisions is that the employer's retention of an unqualified right to amend or terminate evinces an intent by the employer not to be bound by contract. Put another way, the employer's reservation of rights reflects an intent to perform for only so long as it wishes to do so. Thus, the parties do not have mutual obligations, a cornerstone of contract law.

However, under New York law, a party who has performed is likely to have better luck, because New York does not treat the absence of mutual obligations as an automatic bar to a breach of contract claim. See *Faust Harrison Pianos v. Allegro Pianos*, No. 09 CIV. 6707 ER, 2013 WL 2292050, at *11 (S.D.N.Y. May 24, 2013) ("Under New York law, courts should avoid a contractual interpretation that renders an agreement illusory and unenforceable for lack of mutuality—i.e., lack of consideration.").

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Instead, courts will look to the parties' performance. See 22 N.Y. Jur. 2d Contracts §11 ("Although a contract generally will not be found where mutuality is lacking, the absence of mutuality of obligation may be remedied by the subsequent conduct of the parties."); *Aquavit Pharmceuticals v. U-Bio Med*, No. 19-CV-3351 (VEC), 2020 WL 832249, at *3 (S.D.N.Y. Feb. 19, 2020) ("[W]hen the obligation of a unilateral promise is suspended for want of mutuality at its inception, [] upon performance by the promise, a consideration arises which relates back to the making of the promise; and it becomes obligatory.") (alterations in original) (quoting *Grossman v. Schenker,* 206 N.Y. 466, 468 (1912)); *Ferguson v. Ferguson*, 97 A.D.2d 891, 892 (3d Dept. 1983) ("The absence of mutuality of obligation 'may be remedied by the subsequent conduct of the parties ***'") (internal quotation marks and citations omitted).

Conclusion

Employment contracts typically involve a tension between an employer's desire for flexibility and an employee's desire for predictability. Negotiations over these contracts usually involve some give and take. The key for enforceability is to make sure that the written agreement does not permit the employer to take that which it promises to give.