Employment Law Information in a Nutshell (No. 4 / 2005)

Allegedly Revocable and Voluntary Benefits – Pitfalls in Form Employment Contracts

A topical judgment of the Federal Labor Court of Germany gives reason to comment on the problems of revocable and voluntary benefits in form employment contracts.

In addition, a look shall be taken at some other provisions often used in standard forms which may be problematic.

Reservation of the right to amend provisions in form employment contracts – Federal Labor Court, Judgment of January 12, 2005 - 5 AZR 364/04

Contractual provision required

It is in the employer's interest to provide for employment conditions as flexible as possible, in particular as regards components of the remuneration. A binding effect for the future shall be avoided. This applies in particular to benefits granted in addition to the base salary. However, if an employer grants e.g. annual special payments, Christmas bonuses or allowances above the general pay scale without any reservation, he will later generally not be entitled to amend, curtail or cancel these payments without the employee's consent.

In practice: "proviso of cancellation"

Therefore, upon the grant of the benefits, employers have often reserved their right to cancel the continued grant of these benefits at any time in the future.

Ineffectiveness of the reservation to cancel continued payments at any time

Reservation to cancel continued payment of benefits at any time → null and void

The Federal Labor Court (judgment of January 12, 2005, 5 AZR 364/04) now clearly declared the reservation in form employment contracts (which are presented not only to a single employee but to several employees) to unilaterally cancel, i.e. to stop the continued payment of benefits, or to amend employment conditions null and void. According to the Federal Labor Court, a reservation of cancellation is only valid if the employee can be reasonably expected to agree thereto. This condition is only met if the limits of appropriateness and reasonableness are observed (section 308 no. 4 German Civil Code). This is not the case if the employer reserves the right to cancel the continued payment of benefits without any restrictions at any time. A clause which does not meet these requirements is invalid. Consequently, the employer is obligated to grant the benefits in the future as well. Further, it is not possible to reinterpret the invalid clause and to replace it by a clause which is still valid but most closely effects the purpose of the invalid provision.

Requirements for a valid reservation to cancel benefits

Revocation must be clearly specified

A valid reservation requires that its wording clearly states that payments will not be cancelled, i.e. stopped without any reason, **and** possible reasons for a future cancellation must already be specified. Based on the provision, the employee must already know under what circumstances he must expect a cancellation. Possible reasons for making use of the right of cancellation are, e.g.: economic and financial distress of the company, negative results of the business department, insufficient profits, decline of the expected economical development, performance of the employee under average or severe breach of duties.

Possible reasons

Approaches to resolve the problem

Contracts with new employees

Possible reasons for a future cancellation must be specified in detail in employment contracts with new employees.

Old contracts

Re-Interpretation of old contracts

The Federal Labor Court left open the following "back-door" for contracts that were entered into already prior to January 1, 2002: Since at that time the employer could not have knowledge of the statutory provisions, which have applied to form employment contracts (sections 305 et seq. German Civil Code) since January 2002, the old cancellation clauses shall not be invalid only because the reasons for cancellation have not been specified. Therefore, these clauses can be reinterpreted and the employer shall be in the same legal position as if the parties had at least provided for the right to stop the payment of benefits based on economic losses or distress.

Revocation must be exercised in a reasonable way

Please note that nonetheless the right of revocation can only be applied to components of the remuneration not exceeding 25 to 30% of the total remuneration. In addition, the right of cancellation must also comply with the principle of reasonably exercised discretion in the individual case. Therefore, a notice period or expiration period may have to be granted.

„Voluntary" benefits are not necessarily voluntary

Voluntary benefits

Another way to keep parts of the remuneration flexible is to grant (only) voluntary benefits. Voluntary means that the employee shall not have any legal claim for the respective payment in the future. Therefore, the employer shall have the right to cancel these benefits without any restrictions.

Also in this regard, however, the employer should be careful: Not every so-called "voluntary" benefit is actually legally voluntary. This applies in particular if it is unclear whether already the grant of the benefit itself or only further application shall be voluntary.

Wording is decisive

The Federal Labor Court decided (judgment of April 28, 2004 - 10 AZR 481/03) that the mere characterization of an anniversary bonus as „voluntary social benefit“ does not lead to the conclusion that this benefit was granted only with reservations. The employee could not realize that the employer thereby wanted to reserve the right to freely cancel the payment in the future. The employee could also have the understanding that the employer assumed voluntarily the obligation to pay the benefit, i.e. without being obligated to grant this benefit by law, collective bargaining agreements or shop agreements.

Recommendation

To make sure that the voluntary benefits are actually legally voluntary, the employer should explicitly clarify that the payment or the grant of the benefit (e.g. an additional vacation day) constitutes a “voluntary benefit” and that even recurring payments / a recurring grant do / does not create a legal right to the benefit in the future. Providing for this clause is the only possibility to avoid a contractual claim for the future.

To be avoided: “voluntary and under reserve of cancellation”

At any rate, the employer should not use the following clause, which is still often agreed in practice but which is a contradiction in terms: “The benefit is granted voluntarily and under reserve of cancellation.” This clause incorrectly mixes the clause used for voluntary benefits and the clause used for benefits granted under reserve of cancellation. Benefits are either granted voluntarily or the employee has a contractual claim which, however, can be cancelled for specific reasons in the future. If the contradictory stipulation is used nonetheless, it is interpreted as clause for benefits granted under reserve of cancellation. The characterization of the benefits as voluntary has no effect. Consequently, a cancellation of the payment of the benefit in the future requires to be based on an objective reason; further, making use of the right of cancellation must comply with the principle of reasonably exercised discretion in the individual case.

Other pitfalls in form employment contracts – some examples

„Requirement of writing” for amendments - “Extended clause” prevents the establishment of an operational practice

Many employment contracts provide that any modification of or amendment to the contractual provisions requires the written form to be legally valid. However, if the employer wants to avoid the establishment of an operational practice (e.g. claim for payment of a Christmas bonus resulting from a respective grant in several subsequent years without any reservation), he must take a further step and stipulate additionally that also the amendment of the requirement of the written form itself must be made in writing. Whereas the simple requirement of writing for modifications and amendments can be invalidated verbally and by conduct implying an intent, this does not apply to the extended clause as described above.

Cut-off periods

Caution is also advised with regard to the use of cut-off periods. Respective clauses stipulate that claims arising from the employment must be asserted – generally in writing – within a specific period of time (1st sep) and, in case the employer rejects the claim, legal action must be taken within another period (2nd step). Future jurisdiction will show if and to what extent these clauses are still valid if they are part of a form employment contract. The German Federal Labor Court (judgment of May 25, 2005, 5 AZR 572/04) holds the view that the parties must at least provide for a period of three months for the second period (minimum period for taking legal action).

2nd Step: Minimum period of three months

Typographically highlighted

Cut-off periods ought to be typographically highlighted in order to avoid that the respective provision is deemed to have a surprising effect and is therefore invalid (section 305 c German Civil Code).

Liquidated damages

Also liquidated damages clauses should be highlighted clearly. The scope of their application as well as their amount must be reasonable and clearly defined. If the amount of the liquidated damages is too high, the liquidated damages clause is invalid. The liquidated damages cannot be reduced to a reasonable and permissible amount by reinterpreting the clause. Further, when drafting the contract the employer must ensure that the breach of duty, which shall trigger the claim for liquidated damages, is described as precise as possible. Any ambiguity or lack of clarity has a negative effect on the employer's side.

Recommendation for daily practice

Adapting

When concluding new employment contracts or amending contracts, the employer should not only comply with the new legal requirements for form employment contracts (sections 305 et seq. German Civil Code) but he should also observe the recent judgments of the Federal Labor Court. Unwanted claims can be avoided thereby.

Optimizing

If possible, old employment contracts should be optimized at the next opportunity.

Individualizing

Form employment contracts are only forms; drafting employment contracts individually so that their content differs can help that these provisions do not have to comply with the strict regulations for form contracts pursuant to sections 305 et seq. German Civil Code.

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