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PILONS AND PENALTIES

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Introduction

1 Two main issues arise in relation to termination clauses in contracts of employment: (1) the interpretation of pay in lieu of notice ("PILON") clauses in the light of *Cerberus v Rowley*[1]; and (2) whether a termination clause providing for the payment of a lump sum may be a penalty clause. Recent case law also suggests that it is worth considering how the Unfair Contract Terms Act ("UCTA") may apply to termination clauses in employment contracts.

Summary

2 Each of the issues referred to above may be said to illustrate attempts by the law to modify, or mitigate, the effect of what the parties to the contract actually agreed.

3 Whether or not a PILON clause creates a debt is a question of construction; it will depend on whether the clause provides the employee with an entitlement to PILON. It has been suggested that there are policy reasons for the law to develop further in the light of the important principle that a person should not be able to benefit from his own wrong. But the courts have held that if no entitlement to PILON exists in the first place, then the wrongdoing party is not, in fact, benefiting from his wrongdoing by having to compensate the employee for his loss rather than paying a debt (the damages being in respect of the breach of the employee's right to notice, not notice pay).

4 Clauses that stipulate that the employer or employee has to pay a lump sum in respect of a breach of contract may not survive the court's scrutiny, as they may be held to be penalty clauses.

5 UCTA has been held to be relevant to the court's interpretation of the contract, though only in favour of the employee. However, the authors are unaware of any decision involving an employee successfully relying on the statute.

6 Contractual principles of interpretation of course apply to employment contracts as they apply to all contracts, but the employment contract is a very particular creature. The

[1] [2001] IRLR 160, CA

unequal bargaining power that generally exists between employer and employee has to some extent been mitigated, not only by special statutory protection for the worker, but also by an approach to the interpretation of employment contracts that often considers relevant the context in which those contracts are made. The concept of "freedom of contract" is a less powerful one when the nature of the contract is an employment and not a purely commercial one. These considerations play a part in the law's approach to the issues discussed below.

PILON Clauses

7 The main issue that arises in relation to PILON clauses is the extent to which such clauses give employees a right to insist on being paid the full amount of what they would have earned during notice as a debt, as opposed to providing the employer with an option to do so, if it suits him. Linked to that question is the issue of the extent to which a PILON may work to the benefit of the employer by providing him with a choice of lawful methods of termination.

8 In *Rex Stewart Jeffries v Parker*[2], the contract provided that the employee's contract could be "determined by the giving in writing of six calendar months' notice on either side or the payment of six months' salary in lieu thereof." The employer sought to terminate the contract summarily on the payment of six months' pay in lieu. When the employer subsequently sought to enforce a non-solicitation clause in the contract, the employee argued that it was unable to do so because it was in repudiatory breach of contract by failing to give notice. The High Court and the Court of Appeal rejected that argument and held that the contract provided for two alternative methods of terminating the contract, either by six months notice or pay in lieu, each being a lawful method of termination.

9 In *Abrahams v Performing Rights Society*[3], the relevant clause provided that an employee "would be entitled, other than in the case of dismissal for gross misconduct, to a period of

[2] [1988] IRLR 483
[3] [1995] IRLR 486; [1995] ICR 1028, CA

notice of two years or an equivalent payment in lieu." The employer chose to dismiss without either notice or pay in lieu. The employee argued that he was entitled to a payment representing the full two years as a debt, without any duty to mitigate his loss or give credit for any sums earned in alternative employment, and the Court of Appeal agreed.

10 In the light of this decision, PILON clauses began to fall into a degree of disuse as employers' legal advisors pointed out the perils of an employee with a long notice period being able to enforce it and receive a windfall payment, regardless of any actual loss.

11 But in the case of *Cerberus v Rowley*, *Abrahams* was distinguished. In this case the relevant clause provided that "the employer may make a payment in lieu of notice to the employee". The Court of Appeal held that it was the employer alone who had the right to elect whether to provide the employee with 6 months notice of termination or payment in lieu. In the circumstances, the employee did not have a right to PILON and therefore had no debt claim. His claim was one for damages for wrongful dismissal, and the normal principle of mitigation would apply. Where the employee has been wrongfully dismissed without notice, but shortly afterwards gets another job, the compensation he will receive for the breach will be reduced to take account of the salary he receives from his new job.

12 *Cerberus* thus provides a solution for employers who want to include PILON clauses in their contracts (often desirable where an employer has a legitimate reason for preferring the employee no longer to work): the clause needs to make clear that it is the employer who is entitled to elect whether to provide the employee with notice or PILON, and that he is not obliged to make a payment in lieu.

13 The decision in *Cerberus* was not unanimous, however. Sedley LJ gave a powerful dissent. In essence, he argued that the effect of the decision was to reward wrongdoing employers who, instead of giving an employee notice, breach the contract and then refuse to pay PILON. If the employee goes on to find another job soon after, the wrongdoing employer is rewarded because any compensation he might have to pay will be reduced to take account of the employee's new salary. The law-abiding employer who does not breach the

contract but gives the employee 6 months notice and pays him for this period is worse off than the wrongdoing employer. But one obvious difficulty with this approach is that, if the contract on its proper construction provides the employer with the right to elect whether to pay PILON, then he will not, by failing so to elect, be acting wrongfully and hence will not be benefiting from his own wrong. The employer will, of course, be acting wrongfully in failing to give notice, and that will entitle the employee to compensation for his loss, but no more.

14 So, in summary, where on the proper construction of the contract, the employer has no choice but to give notice or to pay PILON (as in *Abrahams*) then PILON should be treated as a debt, but where the contract provides for the employer to have an option as to whether to pay PILON (as in *Cerberus*) and the employer is simply in breach of the obligation to give notice, then the remedy must be in damages and subject to mitigation[4].

15 A further variation on this theme is illustrated by *Breakspear v Colonial Financial Services (UK) Ltd*.[5] The employer had the right to elect to make a PILON and did so. However, a dispute arose as to the correct amount payable – something that can often arise where commission and bonus payments are involved. The employee sued, and the court found, distinguishing *Cerberus*, that the PILON was to be treated as a debt and thus not subject to mitigation. This was because the employer, having elected to make a PILON, had created an entitlement to one.

16 The net result of the case law appears to be that the sensible course for employers is to keep all their options open by including a *Cerberus* type clause in the contract – one that in effect gives them three choices: lawful termination with notice, lawful termination without

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[4]In *Hardy v Polk (Leeds) Ltd* [2004] IRLR 420, an unfair dismissal case, the EAT referred to *Cerberus* as setting out a general principle of mitigation, and made it clear that there was no such thing as entitlement to notice pay, if no loss was in fact suffered in that period. The EAT has recently applied this principle in deciding that an employee had to give credit for incapacity benefit in relation to an award of compensation for unfair dismissal: *Morgans v Alpha Plus Security Ltd* [2005] IRLR 234. In *Voith Turbo Ltd v Stowe* [2005] IRLR 228, however, a differently constituted EAT applied *Norton Tool Co Ltd v Tewson* [1972] IRLR 86 and held that it was open to an ET to decide in accordance with good industrial relations practice that a former employee who obtains new employment during a notice period is not obliged to give credit for it.

[5] *Unrep*. QB, 30 April 2002

notice but with a PILON, and lastly unlawful termination without notice in breach, for which the employee can only claim damages. For the employee, on the other hand, the target must be the kind of clause that was used in *Abrahams*.

Penalties

17 A termination clause may provide for an employee who is in breach of contract to pay monies to the employer for the losses the latter will suffer as a result of that breach or vice-versa. For instance, a key employee may resign without giving notice exposing the employer to substantial losses. To protect against this the employer may have a clause in the contract entitling it to compensation for the losses suffered. However, the drafting of such a term poses considerable difficulties. Forecasting before the breach takes place what is a genuine pre-estimate of damage can be particularly difficult in an employment situation. The danger for the employer is that the clause will be struck down as a penalty clause.

18 The classic statement of law set out by the House of Lords in *Dunlop Tyre v New Garage*[6] as to whether a clause is a penalty or liquidated damages clause applies to the employment contract as to any contract. In brief:

18.1 The expression (liquidated damages or penalty) used by the parties may be *prima facie* evidence of what is intended, but it is not conclusive.

18.2 The essence of a penalty is a payment of money stipulated as a warning or deterrent to the offending party; the essence of a liquidated damages clause is a genuine pre-estimate of damage.

18.3 Whether a term is a liquidated damages or penalty clause is a question of construction to be decided upon the facts of each particular contract at the time of making the contract, **not** at the time of breach.

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[6] [1915] AC 79 (at pp.86-88)

18.4 The following tests assist this task of construction, and may be conclusive:

(1) It will be a penalty if the sum stipulated is extravagant and unconscionable in amount in comparison with the greatest loss which could be proved to have followed from the breach;

(2) It will be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is greater than the sum which ought to have been paid;

(3) There is a presumption that it is a penalty when a single lump sum is payable by way of compensation on the occurrence of one or more or all of several events, some of which may occasion serious and others trifling damage;

(4) But, it is no obstacle to a sum being a genuine pre-estimate of loss that the consequences of breach makes a precise pre-estimation almost impossible – that is the type of situation when it is probable the pre-estimated damage was the true bargain between the parties.

19 A particular difficulty that arises in the context of the employment contract is where the payment stipulated is not graduated to reflect the loss estimated. This situation can often arise where a person resigns without giving notice. The employer's loss is unlikely to be for the whole period of the notice – because he will usually find a replacement employee for some or all of that period. However, as he cannot estimate beforehand how long it will take to find a replacement, it is very difficult to estimate the loss in advance. If the clause stipulates for a single lump sum payment to be made by the employee who resigns without proper notice, rather than for different payments depending on the circumstances (for example, on whether the employee has given any and if so how much notice), the clause may be construed as a penalty clause.

20 In *Giraud UK Ltd v Smith*,[7] the EAT considered a clause in an employment contract that stipulated:

> "Unless agreed otherwise, failure to give proper notice and work it will result in a deduction from your final payment equivalent to the number of days short."

21 Whilst on its face this appears to get round the objection that the estimate of loss is not graduated to reflect the employer's genuine loss, it in fact does not do so. The calculable sum bears no sufficient relation to the employers' likely or actual loss. In *Giraud* the case involved a driver working for a transport company. The notice period was four weeks. The employee left without giving any notice. The employer deducted from his final payment due on the date of his resignation a sum equivalent to four weeks' wages under the clause. It was not difficult for the employer to find a replacement driver within a short period, so that his loss might be minimal or zero. However, were this the case the employee would still have his final payment reduced by the amount of four weeks' wages pursuant to the relevant clause. On this basis, the EAT held that the calculable sum was not a genuine pre-estimate of the employer's loss, but was an unenforceable penalty.

22 The *Giraud* case demonstrates how difficult it can be to include an enforceable term stipulating a payment that may be made by an employee who resigns without giving and working his notice period. It is often better for the employer to avoid such a term altogether. Where the resignation of an employee without notice causes substantial losses the employer can sue the employee for breach of contract in any event, and could recover his losses subject to the principles of mitigation. In most circumstances it will be so difficult to estimate what the losses might be before breach that the inclusion of a clause that purports to do so will be more trouble than it is worth.

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[7] [2000] IRLR 763

23 The same problem can arise in relation to clauses that stipulate for lump sums to be paid to employees when their contracts are terminated without notice. For example, in *Duffen v FRA.BO SpA*,[8] the Court of Appeal considered the construction of a clause of an agency agreement purporting to be a liquidated damages clause. The agent was entitled to terminate the agreement if the principal failed to pay any sums due within a specified period of time, and if he did so, the clause stipulated that the principal pay the agent a lump sum which was purportedly an estimate of the losses the agent would suffer as a result of the principal not paying the agent sums for the remainder of the contract. But the lump sum was payable irrespective of the unexpired duration of the term. The agent could recover a substantial windfall if, for instance, termination occurred in the last month of the contract's life. In those circumstances the clause was held to be a penalty clause and unenforceable.

24 One interesting question that has only recently begun to be explored by the courts is whether a PILON clause may be a penalty. Indeed in *Humphries v CEDEF Assets Limited* (14 December 2001, Butterfield J), a PILON clause was held to be unenforceable as a penalty by Butterfield J, applying the *Duffen* case.

25 In *Kenneth Christopher Murray v Leisureplay Plc* [2004] EWHC 1927 (QB) (at first instance), the clause under consideration was a PILON clause which provided for 3 years pay in lieu of notice. It was argued by the defendant that the clause was an unenforceable penalty, because (among other things) it failed to take account of the fact that the first £30,000 of any liquidated damages claim would be tax free, and failed to take account of the fact that the claimant would not have to pay National Insurance contributions on his liquidated damages. Stanley Burnton J did not rule on these arguments, but decided that the clause was a penalty because it took no account of the claimant's duty to mitigate his damages. That was sufficient in itself to make it a penalty.

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[8] *The Times*, 15 June 1998 (30 April 1998).

26 However, the Court of Appeal[9] overturned the decision of Stanley Burnton J in *Murray*, finding the clause was not a penalty. The fact that the claimant's employment terms were generous (and more than he was likely to receive in common law damages as they failed to take into account the duty to mitigate) did not mean they were "extravagant and unconscionable". The fact that the claimant was the founder of the company and negotiated the terms of his contract with its directors meant there was no real inequality of bargaining power. It was impossible to estimate, exactly, what might happen if the claimant was dismissed and it was in the interests of both parties to know the position to avoid dispute in the future.

27 Although there were special facts in *Murray*, as there are in all cases, the approach of the Court of Appeal deserves special attention and is likely to influence future decisions on penalty clauses. Arden LJ gave the lead judgment, although to the extent Buxton LJ's approach differed from hers, his represents the judgment of the Court.

28 Buxton LJ focussed on the recasting of the classic test set out by Lord Dunedin in Dunlop by Colman J in *Lordsvale Finance plc v Bank of Zambia*,[10] asking whether at the time the contract was entered into the predominant purpose was to deter a party from breaking the contract or to compensate the innocent party for the breach. That the purpose is deterrent and not compensatory can be deduced from comparing the amount payable on breach with the loss that might be sustained if the breach occurred.

29 Buxton LJ held that as there were only two alternatives, a deterrent penalty or a genuine pre-estimate of loss (and nothing in between), if the court cannot say with confidence the clause is intended as a deterrent it will find it to be a genuine pre-estimate of loss. So long as the clause is compensatory in nature rather than meant as a deterrent then even if it is generous it will not be a penalty.[11]

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[9] [2005] EWCA Civ 963; [2005] IRLR 946.
[10] [1996] QB 752 at 762G and cited with approval by Mance LJ at para 13 of his judgment in *UIP v Cine* [2003] EWCA Civ 1699; [2003] All ER (D) 312
[11] See para 111 of the judgment.

30 The approach in *Murray* would appear to place the focus more on proportionality than on precise pre-estimations of loss. In future courts are more likely to ask whether, in the specific circumstances of the case (e.g. the difficulties of forecasting the extent of the loss, the inequality of bargaining power etc.) a clause that allows one party generous compensation is disproportionate to what he would have achieved in common law damages, and not whether it is simply more than such an amount, or on whether it was too difficult to pre-estimate loss. The result of this approach should mean the courts are less likely to strike down clauses as penalty clauses than they have been in the past, although clauses similar to those struck down in the past, such as when all employees must pay the same penalty regardless of their circumstances if they resign without notice, are still likely to be classed as penalty clauses.

UCTA

31 Another way in which the courts may interfere with a contract of employment and interpret a termination clause against the apparent intention of the parties is through UCTA. It has recently been held that UCTA may apply to employment contracts, and the case law on this point is still in its infancy. The leading case is the decision of the High Court in *Brigden v American Express Bank Ltd.*[12] The claimant had been employed as the regional head of sales of the defendant company. After only 12 weeks he was summarily dismissed with 3 months PILON. The company had failed to follow the contractual disciplinary procedure in dismissing him. The employer claimed they were entitled to do so because a clause on the contract provided that:

> "An employee may be dismissed by notice and/or payment in lieu of notice during the first two years of employment without implementation of the disciplinary procedure."

32 On the facts, the court found that the clause did not fall within section 3(2) UCTA as it did not restrict or exclude the employer's liability, or entitle the employer to render substantially different contractual performance from that reasonably expected of them,

[12] [2000] IRLR 94

or render no performance whatsoever – the clause had set out the claimant's entitlement in clear, though negative, terms. However, the important decision of the court was that contracts of employment fell within section 3 UCTA.

33 Section 3 UCTA concerns a party dealing *"as consumer"* or on the other's written standard terms of business.[13] The other party cannot, by reference to a contractual term, exclude or restrict his liability in respect of a breach,[14] or claim to be entitled to render contractual performance substantially different from that reasonably expected of him, or render no contractual performance at all, except insofar as the term satisfies the requirement of reasonableness.[15] The Court correctly held that s.3 UCTA must be read with s.12 UCTA which defines "deals as consumer". Section 12(1) UCTA provides:

> "A party to a contract "deals as consumer" in relation to another party if –
>
> (a) he neither makes the contract in the course of a business nor holds himself out as doing so; and
>
> (b) the other party does make the contract in the course of a business; and
>
> (c) in the case of a contract governed by the law of sale of goods or hire-purchase, or by s.7 of the Act, the goods passing under or in pursuance of the contract are of a type ordinarily supplied for private use or consumption."

34 Moorland J found that it was the clear intention of Parliament, on a proper interpretation of UCTA, that s.3 applies to employment contracts and an employee deals as a consumer so long as s12(1)(a) and (b) are fulfilled – and clearly those provisions will be fulfilled in most employment contracts. Moorland J accepts this is a rather "artificial" meaning, but is fortified by Schedule 1 UCTA, paragraph 1 of which sets out contracts

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[13] Section 3(1) UCTA
[14] Section 3(2)(a) UCTA
[15] Section 3(2)(b) UCTA.

not covered by ss 2-4 UCTA (and does not include an employment contract), and para 4 of which reads:

> "Section 2(1) and (2) do not extend to a contract of employment, except in favour of the employee"

35 Although UCTA has previously been considered to only concern consumer protection law, Moorland J's interpretation would appear to be correct. This is perhaps a little less surprising when one considers that the purpose of UCTA (the protection of the *consumer*, i.e. generally the weaker party in the bargain) reflects the purpose behind a large body of employment law (the protection of the *worker*, the generally weaker party in the bargain).

36 Since the decision in *Brigden* there have been few examples of UCTA being relied upon before the courts or tribunals. UCTA may be relevant to issues such as the unreasonable operation of contractual merit pay systems or performance appraisals, for instance. However, in another more recent case concerning a termination clause, UCTA was found not to apply. In *Peninsula Business Services Ltd v Sweeney*[16] the EAT considered a clause that provided an employee would not receive payment of commission he had earned during his employment if he was not employed at the time the commission became payable under the company's scheme. The employee had resigned at the time his commission payment of £20,000 became payable, and he was therefore not entitled to it. One of the arguments before the EAT was whether the relevant contract term was a clause to which s. 3(2)(b) UCTA applied. The EAT held that s.3(2)(b) of UCTA did not apply as the relevant clause was not a term claiming to entitle the employers to render a contractual performance substantially different from that reasonably expected of them – it was clear at the time the employee signed the contract what the clause meant, and the employer was entitled to rely on it.

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[16] [2004] IRLR 49, EAT

37 There have been no reported cases applying UCTA to employment contracts since 2004, suggesting that, whilst there may be some room for creative arguments about the application of UCTA to employment contracts in general, a clear termination clause is unlikely to be effected by the statute.