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Employment Settlement Agreements – how to avoid the common pitfalls

Settlement agreements are a pragmatic and effective tool in resolving workplace disputes. The employee benefits from financial support and a dignified exit, and the employer achieves a clean break. However, when used improperly, employers can end up in hot water with HMRC, the Employment Tribunal, or even the press.

Our September client alert looks at the common areas employers trip up on when it comes to parting ways with employees via settlement agreements.

MISUSE OF "GAGGING" CLAUSES – BE MINDFUL OF THE LIMITATIONS ON CONFIDENTIALITY CLAUSES

The #MeToo movement shone a spotlight on the misuse of non-disclosure agreements (**NDAs**) to "gag" and intimidate victims of sexual harassment. There is no legal definition of a "gagging clause", but it often refers to confidentiality obligations (normally in a settlement agreement) that prevent an employee from discussing the circumstances leading up to the settlement to conceal a crime or unlawful treatment.

Confidentiality undertakings are a common feature of settlement agreements and there are currently mixed views about how far they can go. In some cases, there may be a legitimate need to protect commercial interests, mitigate reputational risk or it might benefit the employee for a sensitive matter to be kept private. So how can an employer tell whether a confidentiality clause is fairly drafted or not?

First and foremast, a confidentiality clause can never prevent anybody from 'blowing the whistle' or reporting a crime to the police. The Employment Rights Act 1996 (**ERA**) renders any provision that restricts a worker from making a protected disclosure void. Most employers already carve out protected disclosures from the scope of confidentiality clauses, but it is advisable to explicitly permit disclosures to law enforcement agencies and regulators.

In the wake of #MeToo, the Equality and Human Rights Commission (**EHRC**) published good practice guidance on the use of confidentiality agreements in relation to sexual harassment and all other forms of discrimination. Key points include:

- Consider on a case-by-case basis whether an NDA is needed.
- Weigh up the reason for the NDA and benefit to employer with the impact on the employee and organisational culture.
- Limit the NDA to what is necessary and appropriate in the case (for example, only the settlement payments). Is it really necessary to prevent an employee from speaking about the circumstances leading to their termination?
- Make it clear from the wording what the employee can or cannot do, and that the agreement does not stop them from speaking about any form of harassment or discrimination.
- The wording should allow the employee to have discussions with legal or tax advisers, medical professionals or counsellors, partners or immediate family members (provided they also keep the matter confidential), their trade union, HMRC and a potential employer (where it is necessary to discuss the circumstances in which their previous employment ended).
- Do not put workers under pressure to sign a confidentiality agreement. Allow them time to reflect and discuss it with an adviser.

ACAS issued similar guidance, advising that NDAs should not be used to stop someone from reporting discrimination or any form of harassment. ACAS went further than the EHRC in suggesting NDAs should not be used to avoid addressing problems in the workplace or to cover up inappropriate behaviour, particularly if there is a risk of recurrence.

It is hoped that the UK Government will bring further clarity when it eventually passes the legislation it committed to in 2019 that would make NDAs void unless they complied with certain requirements. Following a public consultation, the Government stopped short of banning NDAs in relation to harassment and discrimination, but committed to measures which would:

- Require confidentiality clauses to include clear and specific reference to their limitations and for independent advice to be taken on this;
- Prohibit NDAs from preventing individuals from disclosing information to the police, regulated health and care professionals or legal professionals;
- Produce guidance on the wording of confidentiality clauses for legal professionals; and
- Introduce new enforcement measures for non-compliant NDAs.

Where used in settlement agreements, the wording of any confidentiality clauses should be drafted sensitively in light of the circumstances and not go beyond what is appropriate.

"WITHOUT PREJUDICE" – HOW AND WHEN TO USE IT

Sometimes employers trip up by mistakenly labelling a difficult conversation with an employee as "without prejudice" and believing that nothing said can later be used against them in an employment tribunal or court. A clear indication of an intent to dismiss at an early stage of a performance management or disciplinary procedure could later be used as evidence of predetermination, unless without prejudice genuinely applies.

"Without prejudice" means that statements made in the course of negotiations cannot be used as evidence in any court or tribunal proceedings. It can apply to email correspondence or discussions with an employee (provided they agree to

speak on a without prejudice basis). Make sure that you obtain the employee's consent to speak off the record, ideally witnessed and noted by someone other than the person initiating the conversation. Make sure the employee understands what without prejudice means and also do not commit anything to writing, even in without prejudice correspondence, which you would not want to see in the open. We have seen a number of recent press reports of without prejudice correspondence being published when there was no dispute and so may have been an abuse of process. If something is not genuinely without prejudice there is not necessarily anything preventing a party from publishing details.

A settlement agreement and any related email correspondence should always be marked "Without Prejudice and Subject to Contract" to ensure you can negotiate freely without it later being used as an admission of guilt.

Be wary that the "without prejudice" privilege will only apply where discussions are a genuine attempt to resolve an existing dispute. This will usually mean starting a formal procedure on the record before embarking on any such discussion. It is advisable to keep the open procedure going simultaneously and completely separate from any without prejudice discussions. If negotiations reach a stalemate, the employer can then revert to the open procedure.

If no dispute exists, an alternative is to request a "protected conversation", which is a mechanism under the ERA that allows an employer to have an off the record chat about ending employment on agreed terms, often to avoid a time-consuming performance management or disciplinary process.

The concept of a "protected conversation" is different to the without prejudice rules, in that what is said is only inadmissible in so far as it relates to ordinary unfair dismissal claims. It does not protect discussions relating to other claims such as automatically unfair dismissal, discrimination or whistleblowing. Further, the conversation will not be protected if the employer acted improperly during the conversation by putting undue pressure on the employee to enter into a settlement.

It is therefore important not to say that the employee will be dismissed regardless of whether or not he agrees the terms and to emphasise a willingness to continue with the on-the-record process.

GETTING THE TAX WRONG - CALCULATING POST-EMPLOYMENT NOTICE PAY

Since April 2018, employers have been required to undertake a "PENP calculation" (or post-employment notice pay calculation) when making a tax-free termination payment. The calculation is designed to ensure that the pay the employee would have received for any period of unworked notice is subject to PAYE and NICs in full (rather than wrapped up in a tax-free settlement payment). The rules are complex and often increase the costs of both employers and employees in concluding a settlement.

PENP is broadly the basic pay the employee would have received during the unworked period of notice, minus any payment in lieu of notice (**PILON**). It is calculated using the following formula: **((BP x D)/P) – T**, where:

- BP = basic pay in the pay period prior to the date on which notice is given, or if no notice is given, the termination date (the relevant pay period).
- D = the number of calendar days in the post-employment notice period – the minimum notice employer is required to give.
- P = the number of calendar days in the relevant pay period.
- T = contractual or deemed PILON.

Where the employee is paid monthly and the length of notice is in whole months, it is possible to use a simplified formula where P=1 and D can be expressed as months (instead of days). There is also an alternative formula where an

employee's pay period is defined in months, but their notice period is defined in weeks or days. In these circumstances, the value of P will be 30.42 (being 365/12).

If the calculation results in a negative number, PENP is zero and the termination payment may fall within the usual £30,000 tax exemption. If PENP is greater than zero, the excess will be subject to PAYE and NICs.

Settlement agreements should clearly identify how each payment will be taxed and make all tax-free awards subject to a PENP calculation.

Some employers might take the view that tax issues are the employee's problem, so long as there is an indemnity in place. However, an indemnity is worth very little if the employee is not contactable or refuses to pay, in which case the employer would need to sue to recover the amounts (incurring significantly more costs than the indemnity is worth).

The PENP calculation removed the tax advantage in omitting a PILON clause from employment contracts (previously the tax treatment of a PILON depended on whether the employer had a contractual right to terminate by paying a PILON). Employers should ensure that all employment contracts include the ability to make a PILON (of basic salary only), as there is no longer any upside to omitting this.

SETTLEMENT PAYMENTS FOR LEGAL SUCCESS FEES AND INSURANCE PREMIUMS SHOULD BE TAXABLE EARNINGS

Last month, the Court of Appeal overturned an earlier decision of the Upper Tribunal in a tax case concerning an employer's payment to the employees' legal adviser as a success fee (under the terms settlement agreement).

In a group action involving unpaid overtime and allowances, the employees had entered into an agreement with legal representatives for a success fee calculated as a percentage of any settlement sum. The employer paid part of the overall settlement sum directly to the employees' advisers as the success fee, as well as a litigation insurance premium directly to the employees' insurance company, without deduction of PAYE and NICs.

The Court of Appeal ruled that despite being paid directly to third parties, the sums were "earnings" for tax purposes and subject to employment taxes. The mechanism of payment did not change the character of the payment – it still represented unpaid overtime, which would have been taxable earnings if paid at the correct time. Employers should consider the true character of the sums paid under the settlement agreement when determining their tax treatment.

It is standard practice for an employer to contribute to the reasonable legal costs incurred by an employee under a settlement agreement. Such amounts are exempt from employment taxes provided the legal costs are in relation to the termination of the employee's employment and paid directly to the adviser. It will be important for settlement agreements to clearly identify this as a separate obligation and for these amounts to be unconnected with the individual's services as an employee.

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