

Chapter 3

Terms of engagement and clauses to consider

Dates of agreement

Every service agreement should include the date on which it is entered into, the date on which the employment is to begin, and the date on which any earlier period of continuous employment began.¹ The latter is not a matter for negotiation since it must be ascertained strictly by reference to the statutory test.² However, if the parties are agreed on the correct date a statement to that effect is certainly helpful.

Contracting parties

The contracting parties must be clearly identified. Usually this presents no problem but some cases may call for special consideration. When dealing with a large group of companies for example, there may be a choice as to which particular company should enter into the agreement. This is no less important when, as part of his duties, the employee may be required to work for other companies in the group; the employee may in fact be seconded to such companies from time to time. For his part the employee will no doubt prefer to contract with a UK company rather than, for example, a foreign subsidiary.

Some undertakings with more than one legal personality can be remarkably light-hearted about their contractual identities. For this reason whenever a service agreement or employment particulars are contained in a letter it is important that the correct letterhead be selected.³ It is not

¹ This is one of the matters which must be included in the written employment particulars supplied under the Employment Rights Act 1996, Part I.

² *Carringtons v Harwich Dock Co Ltd* [1998] IRLR 567, [1998] ICR 1112, EAT.

³ See *Smith v Blandford Gee Cementation Co Ltd* [1970] 3 All ER 154 (Company issuing employment particulars estopped from denying it was the employer).

unusual for a large trading concern to designate one arm of its business as a separate 'Division', with its own trading name and accounts, but this must not be mistaken for a separate legal entity.

In some cases a director's service agreement may need the approval of the shareholders,⁴ a point which should always be checked with the Articles of Association.⁵

Recitals

Most service agreements, indeed most commercial agreements of whatever description, are usually improved by a short recital or introduction. At the time this may seem superfluous but at some time in the future it may prove a useful aid to construction. Recitals may include a reference to any earlier period of continuous employment (as mentioned above) any other relevant employment history and any directorships or other offices which the employee already holds, or to which the employee expects to be appointed.

Employee's warranties

The employee will sometimes be asked to give certain warranties which may be incorporated into the service agreement or set out in a side letter. The warranties may refer to:

- (a) academic and professional qualifications;
- (b) legal requirements, for example registration as a medical practitioner;
- (c) any outstanding claims for professional negligence or the like;
- (d) any pending or previous criminal or disciplinary proceedings;⁶
- (e) any past or present disqualifications under the Company Directors Disqualification Act 1986;
- (f) any adverse rulings by statutory bodies under the Financial Services legislation;
- (g) any outstanding contractual obligations, for example restrictive covenants;
- (h) the employee's current passport, driving licence and (where applicable) work permit.

⁴ See Chapter 8.

⁵ In its statutory returns a company is required to give particulars of any previous forenames or surnames of its directors. As an *aide-mémoire* it may be convenient to mention any such names in the service agreement.

⁶ Subject to the Rehabilitation of Offenders Act 1974.

The warranty should acknowledge that a breach will amount to a repudiation of the contract.

Rehabilitation of offenders and Criminal Records Bureau checks

The Rehabilitation of Offenders Act 1974 introduced the concept of a rehabilitation period, after which a conviction is spent. An employee with a spent conviction is not obliged to disclose it, even in reply to a direct question and ‘any failure to disclose a spent conviction ... shall not be a proper ground for dismissing or excluding a person from any office, profession, occupation or employment, or for prejudicing him in any way in any occupation or employment’. The rehabilitation period varies depending on the severity of the sentence and the age of the offender at the time.

There are a number of important exceptions, relating to certain professions, for example doctors and dentists, solicitors and barristers, employees who teach or come into contact with minors and employment in financial services.⁷ Generally speaking however, when these exceptions apply, the candidate should be expressly warned that spent convictions must be disclosed.

One thing is clear, however. There is nothing to prevent an employer from asking pertinent questions, and nothing which requires the applicant to give untruthful answers. In some cases a failure to ask hard questions might indeed be a matter for serious criticism. Nor, in an appropriate case, should an employer hesitate to ask for written warranties, so long as the employer remembers that they may include some statutory falsehoods.

Employers are increasingly relying upon the services of the Criminal Records Bureau (‘CRB’) which is an Executive Agency of the Home Office providing wider access to criminal record information through its disclosure service. This service enables organisations in the public, private and voluntary sectors to make safer recruitment decisions by identifying candidates who may be unsuitable for certain work, especially that which involves children or vulnerable adults. The CRB was established under Part V of the Police Act 1997 and was launched in March 2002. Organisations wishing to use the service can ask successful job applicants to apply for one of two types of check. The type of check required will depend upon the nature of the position. These are called Enhanced and Standard Disclosures, both require a fee but are free of charge to volunteers. Employers should have policies specifying which category of successful applicants and employees will be required to be CRB checked as making this decision on an ad hoc basis may lead to allegations of

7 Rehabilitation of Offenders Act 1974 (Exceptions) Order, SI 1975/1073; Rehabilitation of Offenders Act 1974 (Exceptions) (Amendment) Order, SI 1986/1249; Rehabilitation of Offenders Act 1974 (Exceptions) (Amendment No 2) Order, SI 1986/2268.

unlawful discrimination, particularly when a comparison may be made between other successful applicants of a different race, gender, age, etc.

Competence and ability

By putting himself forward for a particular appointment a candidate impliedly represents that he has the competence and ability which the job requires. It is sometimes suggested that this implied representation should be spelt out in the service agreement as an express warranty of reasonable competence. This is a matter of personal preference. It might be thought that a truly incompetent candidate is unlikely to be appointed to a senior position and equally unlikely to retain it. Much more common is the employee who, while not truly incompetent, simply fails to perform as well as expected. In that type of situation, it is suggested, a contractual warranty is unlikely to be of any real assistance.

More to the point will be the usual covenant for diligent service, perhaps with the addition of the phrase 'to the best of his skill and ability'.

Good health

A senior appointment is sometimes offered subject to a satisfactory medical examination which may deal with the employee's mental as well as physical health. There are no restrictions governing such reports when prepared by a medical practitioner nominated by the employer. However a report obtained from the employee's own doctor will be subject to the detailed provisions of the Access to Medical Reports Act 1988. Of these the most important is that the individual is entitled to see and comment on the report before it is supplied to his prospective employer. Employers also need to be mindful of the obligations placed upon them by the Disability Discrimination Act 1995 such as the obligation to make reasonable adjustments.

Job title

The employee may attach some importance to the job title and the status it carries. Often the title will have been stated in a recruitment advertisement or a letter of offer. It may have some contractual significance especially if, for example, at some later date there should be a reallocation of duties, or an internal reorganisation. The title should not be unduly restrictive⁸ nor so vague as to be virtually meaningless. In some cases a territorial designation may be helpful, e.g. 'Senior Sales Director (Home Counties)' but it may be necessary to stipulate that this will not restrict the scope of the employee's duties and responsibilities.

⁸ See *Churcher v Weyside Engineering (1926) Ltd* [1976] IRLR 402 IT ('Planning engineer').

As to the various titles used for company directors, and the practice of describing senior employees (not on the board) as 'directors', see Chapter 8.

Job description and duties

The job description, usually contained in a separate document, will summarise the employee's duties and responsibilities, identify the staff or department for which the employee is responsible and the person or persons (for example the board of directors) to whom the employee is to report. This type of document is best drafted 'in house' by someone with a detailed understanding of the employer's undertaking and priorities. It may indeed be written as part of a management plan. Alternatively, if the post was advertised, the advertisement may be a useful starting point, at least for an outline of the job description.

Permanent employment

Most service agreements are periodical contracts running on from month to month until either party gives notice. The period of notice should of course be specified, and need not be, although it often is, the same for both parties. For historical reasons this type of engagement, however short-lived, is sometimes called permanent employment.⁹

Fixed-term contracts

A fixed-term contract is terminated at the end of the time specified in the contract, the completion of a particular task or the occurrence or non-occurrence of any other specific event other than the attainment by the employee of a bona fide normal retirement age.

If the fixed-term contract is terminated before its proposed end date the employer will be required to pay for the remainder of the fixed term unless the termination is permitted by a notice provision in the contract. It is often asked how can a fixed-term contract be defined as such if there is an express right to terminate by the provision of notice during the fixed term? – this is a good question and there is no logical answer. Despite this, it is very common for a fixed-term contract to provide for termination before the end of the fixed term subject to a specified period

⁹ At one time many large organisations had both permanent and temporary employees, the terms being used to distinguish those who were and were not working on a permanent basis for the establishment. Temporary employees might not be provided with work all the time or they might be retained for many years. Nowadays the term 'temporary' usually applies to an employee who is supplied and paid by an employment agency.

of notice being provided and such provisions are recommended in most circumstances.

The benefits to employers of using fixed-term contracts have become quite limited. Previously, rights to claim unfair dismissal and redundancy payments could be excluded provided certain conditions were satisfied but this is no longer the case following the introduction of legislation prohibiting this.¹⁰ Also, the introduction of the Fixed Term Employees Regulations (Prevention of Less Favourable Treatment) Regulations 2002 has provided fixed-term employees with additional rights which provide protection against adverse differential treatment when compared against permanent employees involved in the same or broadly similar work having regard, where this is relevant, to whether they have a similar level of qualification and skills.

The main advantages for an employer of fixed-term contracts are that they assist in securing long-term commitment from employees and reduce the risk of claims being raised on the expiry of the fixed term as the reason for dismissal may be argued to be fair (i.e. some other substantial reason) and the employee has been given notice of when his employment should end when signing the fixed-term contract thus removing any surprises.

For obvious reasons, fixed-term contracts are often used for foreign engagements and to provide cover when permanent employees are absent but expected to return to work (e.g. maternity leave, long-term sick leave, etc). They can also be used for a particular academic session, in which case they may be conditional on a sufficient number of students enrolling for the proposed course¹¹ or for project or short-term seasonal work. Fixed-term contracts for company directors are subject to statutory and other controls, which are dealt with in Chapter 8.

Rolling contracts

A rolling contract is a fixed-term contract which from time to time is automatically renewed. An example is a contract for a three-year term, which is automatically renewed after the first twelve months, and so on from year to year, thus ensuring that there are always at least two years left to run. This type of contract is essentially a defensive measure, designed to ensure that if the employee's job is at risk the employee will be well-placed to negotiate substantial compensation. That such an arrangement works to the employee's advantage is obvious; that it benefits the employer, less

10 Section 18 of the Employment Relations Act 1999 and the Fixed Term Employees (Prevention of Less Favourable Treatment) Regulations 2002 repealed s 197(1) and (3) of the Employment Rights Act 1996 respectively. Section 197 permitted an employee to waive his or her right to claim unfair dismissal on the expiry of a fixed-term contract of one year or more and to claim a redundancy payment on the expiry of a fixed-term contract of two years or more.

11 *Wiltshire County Council v National Association of Teachers in Further and Higher Education* [1980] ICR 455.

so. In the circumstances, it is not surprising that such contracts are now viewed with considerable reservation and not normally recommended.

Also, when considering the use of such rolling contracts employers need to consider Regulation 8 of the Fixed Term Employees (Prevention of Less Favourable Treatment) Regulations 2002 which provide that employees who have been continuously employed for four years or more on a series of successive fixed-term contracts are automatically deemed to be permanent employees unless the continued use of a fixed-term contract can be objectively justified.

Hours of work

In the case of a senior employee it is often inappropriate to specify the hours of work. A reference to the 'normal hours of work' may be equally inappropriate if it suggests that any form of overtime arrangement is in place. Often, a flexible formula may be adopted specifying, for example 'such hours as are requisite for the proper performance of [his] duties'. Although theoretically open to the objection that this is too vague to be enforceable, in practice this type of clause does not seem to give rise to any difficulty.

At present the Working Time Regulations 1998¹² apply, broadly speaking, to any adult worker aged 18 or over and limit his working time to 48 hours per week.¹³ But contracting out is permitted and an exception is made for 'managing executives or other persons with autonomous decision-taking powers' who determine their own working hours.¹⁴

Notice and payment in lieu

In service agreements there should be provision for the minimum period of notice required to terminate employment. Whilst it is common for the period of notice required to be given by the employer to be the same as the notice needed to be provided by the employee, this is not always the case and nor does it need to be. It is also common for notice in writing to be required. Although there are minimum periods of notice required to be provided under statute¹⁵, it would be rare for a service agreement of a mid-ranking or senior executive to offend these provisions as notice periods tend to be for a period of at least three months once the executive has completed a probationary period.

A failure to provide notice provisions in a service agreement will result in a term that notice of a reasonable length is implied which will be

¹² SI 1998/1833.

¹³ SI 1998/1833, reg 4(1).

¹⁴ SI 1998/1833, reg 20.

¹⁵ Employment Rights Act 1996, s 86.

determined looking at the circumstances surrounding each case.¹⁶ Whereas reasonable notice for a Sales and Marketing Director has been held to be three months¹⁷, it was decided that 12 months' notice was reasonable for a Director of International Operations.¹⁸

Some agreements expressly permit an employer to dismiss an employee on payment of a sum in lieu of notice. This wording may be beneficial to an employer if post-termination restrictive covenants are important or it wishes to provide that a payment in lieu will be calculated based on salary alone. If an employer dismisses an employee without notice, where there is no express payment in lieu of notice clause, post-termination restrictive covenants will normally be unenforceable and damages will not be limited to loss of salary but will also include loss of benefits and possibly bonus.

A provision for an employer to have discretion to pay in lieu of notice may be a disadvantage when it comes to settling disputes arising from termination of employment. The reason for this is that HMRC will generally regard any ex gratia or compensatory payments paid to employees on termination as including a fully taxable payment in lieu of notice where there is a payment in lieu of notice clause in the service agreement and notice has not been worked. In such a situation a proportion or possibly all of the ex gratia or compensatory payment will be taxable whereas had such a clause been omitted, HMRC may have regarded the payment as not being taxable up to the first £30,000.¹⁹

When it comes to deciding whether or not to include a payment in lieu of notice clause in a service agreement, the advice is that if post-termination restrictive covenants may be important such a provision is highly recommended. As such restrictions tend to be important when drafting service agreements for mid-ranking or senior executives, in such cases payment in lieu of notice clauses are normally included. Where, however, post-termination restrictions are not important (e.g. junior employees in some cases), it is normally best to not include express payment in lieu of notice clauses in employment contracts.

City jargon

A *golden hello* is a bonus paid to an employee on his first joining the company. Typically, it is an incentive to move from one well-paid job to another. *Golden handcuffs* is the name applied to the type of benefit which provides an incentive for the employee to remain with the company, for example a deferred bonus, a loan at preferential rates, or the type of 'forgivable loan'. A *golden handshake* is a sum paid to an employee who leaves on amicable terms, by mutual agreement, although sometimes after some hard bargaining in which the size of the handshake may have been

16 *Clark v Fahrenheit 451 (Communications) Ltd* EAT 591/99.

17 *Rees v Kraken International Ltd* [1975] IRLR 342.

18 *Watson v Faberge Inc.* 22 November 1987, QBD, unreported.

19 Income Tax (Earnings and Pensions) Act 2003, s 403.

discussed. A *golden parachute* provides for an enhanced severance payment on the termination of employment following a particular event such as where there is a breach of contract or failure to renew or for a contingency payment on the occurrence of a particular event such as a change of control of the employing company or its parent company (see Takeover protection below).

Professional advisers should be aware that this is an increasingly controversial area. Most shareholders and institutional investors are prepared to see a retiring director handsomely rewarded after a successful term of office. There is increasing reluctance, however, to reward failure.

Takeover protection

A golden parachute clause (see City jargon above) may provide takeover protection for an executive in the form that an employer cannot terminate for a specified period of time following a change of control; that the executive will be entitled to receive a fixed sum if he is dismissed in breach of contract within a specified period after the change of control; or provide a payment if the employer terminates or the director resigns within a specified period following a change of control. For example, a substantial payment could be triggered if the company terminates the employment prematurely within one year of the takeover or if its conduct during that period is such that the executive is entitled to leave. There may also be provision for certain benefits to continue after employment has ended for a period of time (e.g. the continued use of a company car).

Where a payment is expressed to be payable as liquidated damages in full and final settlement of any outstanding claims, the enforceability of such a term depends on whether the sum in question is a genuine pre-estimate of the anticipated loss. However, the Court of Appeal decision in *Murray v Leisureplay*²⁰ suggests that the courts may be reluctant to find a golden parachute clause unenforceable as a penalty and Buxton LJ commented in this case that 'the traditional learning as to penalty clauses is very unlikely to fit into the description of an employment contract, at least when the penalty is said to be imposed on the employer'.

Before agreeing to takeover provisions employers should consider the requirements of the Companies Act 2006 and in the case of listed companies, corporate governance (see Combined Code, Takeover Code, etc).

Salary

It is usual to stipulate that the employee shall be paid 'a salary of £x per annum, accruing from day to day and payable monthly in arrears'. It may

²⁰ [2005] EWCA Civ 963.

also be useful to stipulate the method of payment, for example by credit transfer to a bank account nominated by the employee. In the case of an employee working abroad it will also be necessary to stipulate the currency of payment and the place where payment is to be made. If any part of the salary is to be retained in the UK, or paid elsewhere, this should also be specifically agreed.

Some draftsmen prefer to indicate, if this be the case, that the salary may be reviewed from time to time, or reviewed annually. This may give the employee some encouragement, but in itself is little more than window dressing. When the time comes the parties may or may not be able to agree on an increase. If they fail to agree, an undertaking to 'review' the salary is in truth unenforceable, since the court cannot act as arbitrator and determine the appropriate uplift.

Among the earliest measures relating to contracts of employment were the Truck Acts²¹ which dated from the 18th century, required wages to be paid in the coin of the realm and prohibited any deductions from the agreed sum. After many generations such protection is now to be found in Part II of the Employment Rights Act 1996. Its practical importance is that any agreed deductions from salary must be specifically authorised in writing unless otherwise permitted by the legislation.²²

Performance pay

Employers sometimes wish to link the employee's pay with his own performance or the performance of the business or undertaking as a whole. There can be no objection to this in principle, but the idea is deceptively simple and can present very real practical difficulties. The problem is to find an accurate measure of the performance which it is desired to reward, and one which will give predictable results over a period of time. This is easier said than done. A simple percentage of the employer's net annual profits, for example, may prove contentious if the figures for one particular year are distorted by some unexpected turn of events. Even without such dangers the correct calculation of the net profits may be open to legitimate argument. The acquisition of one business, the disposal of another, or a change in accountancy practice, may undermine the assumptions on which the original agreement was reached. The passage of time and the march of inflation may have much the same result. Sometimes it may be contended that group accounts have been prepared in a way which does not fairly reflect the performance of individual companies.

These problems can be mitigated by asking the company's auditors to certify the appropriate profits, or commission earned, and for their certificate to be binding on both parties. But this is not always a satisfactory

21 Truck was the vicious system under which workmen were paid in tokens which could only be redeemed at their master's 'Tommy shop'.

22 Employment Rights Act 1996, s 13(1).

solution. It must also be remembered that obtaining accurate financial information about any particular aspect of a company's performance can be a time-consuming and expensive business in itself. For all these reasons an employer who is tempted to agree a commission on profits should at least consider the alternatives of a discretionary bonus and/or a share option scheme.

It is not unusual for new business ventures to be set up offering high rewards to senior executives based on performance and little, if any, guaranteed pay. In such situations, employers must remember the obligations provided under the National Minimum Wage Act 1998.

Residential accommodation

A service agreement sometimes includes provision for the employee's residential accommodation. In such cases the employer's first concern must be to ensure that the employee remains a licensee, obliged to vacate the premises when his employment comes to an end. Under no circumstances should a tenancy be created. To this end, the accommodation itself should always be rent-free, even though the value of the accommodation will doubtless be reflected in the salary. On no account should any part of the salary be specified as referable to the accommodation, for fear that the sum in question should be identified as rent.

Accommodation will normally be taxed as a benefit in kind and an additional liability may arise when the accommodation was obtained at a cost exceeding £75,000.²³

Occasionally a senior employee is required to occupy certain accommodation for the better performance of his duties. In such a case the obligation should always be included in the service agreement, not least because it may be possible to ensure preferential tax treatment. The omission to include such a clause cost the local authority employers dear in *Hughes v London Borough of Greenwich*²⁴ where a headmaster proved to be a secure tenant of a school house and as such exercised his right to buy the property.

Expenses

Without being unduly cynical it may be advisable to specify that the employee will be reimbursed for expenses 'actually incurred'. A claim for 'notional' expenses is not unknown, even from very senior employees. There is in any event an implied obligation to reimburse an employee for expenses properly incurred in the performance of his duties.²⁵ An

²³ Income Tax (Earnings and Pensions) Act 2003, ss 97–113.

²⁴ [1993] 4 All ER 577, [1994] 1 AC 170.

²⁵ *Cosslett Contractors v Quinn* [1990] IRLB 413, EAT.

excessive allowance for expenses may render a contract illegal as a fraud on the Revenue.²⁶

It is also sensible to include a requirement in the service agreement that satisfactory evidence of expenses must be provided before they are reimbursed.

Company car

Many senior appointments include a company car or car allowance as part of the remuneration package, a matter to which employees often attach some importance. Invariably the car will be available for private use, giving rise to a taxable benefit, but here as elsewhere, the tax regime may change from year to year.

For obvious reasons the employer should avoid an undertaking to provide a particular make or model of car. Instead he should undertake to provide a 'suitable' car, or perhaps a car within a certain range of models, while retaining an element of discretion in the final choice. In lean years, deferring the replacement of company cars is sometimes an attractive option and in this respect also, an element of discretion should be built into the contract.

In large organisations there will probably be a separate company car scheme, which may be varied from time to time, although a variation which seriously prejudices the employee may amount to a breach of contract.²⁷

Experience has shown that in severance disputes the company car often assumes disproportionate importance. For this and other reasons, a prudent employer will always retain a spare set of car keys.

Bonuses

Bonuses are normally categorised as either contractual or non-contractual. Whatever formula is adopted the purpose is generally the same, namely to recruit, reward and retain employees whose performance will help the organisation to prosper.

Many bonus schemes provide that the bonus payment is to be payable at the employer's absolute discretion with the intention of providing no obligation on an employer to pay any bonus. When an employer reserves an absolute discretion to pay a bonus it may be difficult for an employee to claim a right to any bonus payment.²⁸

However, it has been seen that courts and Tribunals may hold that bonus schemes referred to as non-contractual or discretionary may still create

26 *Napier v National Business Agency Ltd* [1951] 2 All ER 264.

27 *Keir and Williams v of Hereford and Worcester County Council* [1985] IRLR 505, CA (Social worker's 'essential user' car allowance withdrawn).

28 *Lavarack v Woods of Colchester Ltd* [1967] 1 QB 278.

obligations. An important case in this context is *Kent Management Services Ltd v Butterfield*.²⁹ Mr Butterfield was a recruitment consultant whose letter of appointment referred to a commission and bonus scheme which, it was said ‘for legal purposes ... will be defined as discretionary and ex gratia and will not constitute a contractual arrangement’. Undeterred by this very clear wording, Mr Butterfield, when he was dismissed, brought proceedings in the Industrial Tribunal, as it was called then, complaining that the commission which would ordinarily have been due to him had been unlawfully deducted from his salary under what was then the Wages Act 1986 and is now s 13(1) of the Employment Rights Act 1996. He succeeded, on the wording of the statute³⁰ which defines wages as ‘any ... bonus, commission ... or other emolument referable to his employment, *whether payable under his contract or otherwise.*’ [Emphasis added.] In reaching this decision it has been suggested that the EAT may have overlooked what is now s 13(3) of the 1996 Act, which refers to ‘wages that are *properly payable* ...’. Be that as it may, the Tribunal also suggested that a different wording in the letter of appointment might have produced a different result. Their suggestion was some such phrase as ‘all payments of commission and bonus are dependent upon satisfactory performance and compliance with the contract of employment to the date of the payment’.

Some bonus schemes only provide an employer with a partial discretion to pay a bonus and it has been held that discretion should not be exercised capriciously or in bad faith.³¹ The result of this is that if a discretionary bonus scheme contains a condition that performance will be evaluated before exercising a discretion whether or not to pay a bonus, if the employee’s performance has been good and a discretion is exercised not to pay a bonus, the employee may be able to argue that there has been a breach of contract.

When drafting service agreements it is often useful to refer to a separate bonus scheme document which may be changed annually as this will enable new bonus calculations to be introduced. In such a document it will be useful to specify how the bonus will be calculated outlining which factors will be taken into account.

Employers should also consider inserting conditions into service agreements which provide that for an employee to receive a bonus he must remain in employment and not be working his notice period (given or received) or be on garden leave on the bonus payment date. A provision dealing with pro-rata payment in the years of joining and leaving the employer may also be helpful, as would specification that the bonus scheme is non-contractual if that is the case.

It should be noted that at the time of writing the government and the Financial Services Authority (‘FSA’) are considering ways to discourage banks from paying bonuses that encourage excessive risk-taking and that

29 [1992] IRLR 394, [1992] ICR 272, EAT.

30 Employment Rights Act 1996, s 27(1)(a).

31 *Clark v BET plc* [1997] IRLR 348.

the government is considering giving the FSA the power to cancel any pay deals which appear to reward undue risk-taking. This could have a significant impact on how FSA regulated businesses reward employees, particularly in respect of the bonuses they provide. When drafting service agreements for FSA regulated businesses, it is recommended that any bonus and reward proposals and requirements introduced by the FSA are carefully considered.

Loans and repayments

Lending institutions will often be able to offer their employees, senior and junior, very favourable loan facilities. Again, the details of any such scheme are likely to be contained in a separate policy document.

From time to time, imaginative schemes have also been devised involving forgivable loans. A forgivable loan is a type of deferred bonus. The idea is that when the money is first advanced it forms no part of the employee's remuneration; it is a genuine loan, a sum which the employee has borrowed and which in due course the employee will have to repay. If in two or three years' time (whatever period may be specified) the employee is still working for the company, then and only then will the loan be forgiven. Thus the employee has an obvious incentive to remain, even if he is offered a higher salary elsewhere. The disadvantage of such a scheme is that when, in due course, the loan is forgiven, it becomes a taxable emolument and the tax which the employee will then have to find may be very substantial.³²

Share option schemes

There are various types of share option schemes, but most work on the same general principle. The employee pays a nominal sum for an option to acquire shares at a fixed price at some time in the future, typically in three years' time. The assumption is that by the time the option comes to be exercised the shares will have risen in value, and the employee will make an immediate profit. Should the shares have fallen the employee will have lost nothing more than the nominal sum paid for the option, so the employee's own money is never at risk. Such schemes may be broadly divided into Revenue-approved and non-approved schemes. Revenue-approved schemes yield certain specific tax advantages, but must comply with very detailed statutory provisions. Non-approved schemes also have certain tax advantages and many of the so-called 'executive share option schemes' fall into this category.

The detailed operation of these schemes, closely concerned as it is with

³² For a remarkably ingenious but not conspicuously successful attempt to overcome this problem, aptly described by the editor of *Harvey's Bulletin* as an 'ace wheeze', see *Cantor Fitzgerald International v Callaghan* [1999] 2 All ER 411, CA.

tax benefits, is outside the scope of this book. It will be appreciated however that share options can be a very valuable part of a senior employee's remuneration.

Ordinarily, when a share option scheme is in place, the service agreement will simply indicate that the employee is eligible to participate. The scheme itself will be governed by a separate document, or set of documents, which may include a trust deed. The scheme should expressly stipulate that when the employee's employment ends, for whatever reason, the employee's options will lapse and the employee will be deemed to have waived any claim to compensation for the loss of his rights under the scheme. Alternatively, a clause to that effect should be included in the service agreement. If the wording is sufficiently clear this should eliminate any such head of damage in a claim for wrongful dismissal.

Such was the case in *Micklefield v SAC Technology Ltd*³³ where the relevant clause read as follows:

'If an option holder ceases to be employed within the SAC Technology Group for any reason whatsoever, any option granted to him shall ... lapse and not be exercisable.'

The plaintiff, a former director of the defendant company, claimed damages for wrongful dismissal, the dismissal coming only a few days before his share options matured. The validity of the above clause was tried as a preliminary issue on the assumption that he had been wrongfully dismissed. The plaintiff contended that by depriving him of his share options the company was seeking to profit from its own wrong; alternatively, that the clause was caught by the Unfair Contract Terms Act 1977. He failed under both heads; on the first head because the exclusion clause was clear and unambiguous and on the second because in England, the Unfair Contract Terms Act does not apply to '... any contract so far as it relates to the creation or transfer of securities or of any right or interest in securities'.

It should, however, be remembered that although employees may not be able to successfully claim for loss of share option rights through a wrongful dismissal claim where a 'Micklefield' clause is used, an employee who succeeds with an unfair dismissal claim may successfully claim compensation for loss of share option rights subject to the statutory cap on the compensatory award.³⁴

Practitioners will be aware that share options can be controversial, and that many institutional investors are becoming uneasy at the way they operate in practice. There are a number of concerns. Although they may be promoted as a form of shareholder democracy it is clear that in practice most options go to a handful of top executives. Moreover, there is no evidence that very generous option schemes do in fact produce better company results. Also, as 'scheme shares' account for a growing proportion of a company's capital, the value of existing shares is diluted.

³³ [1991] 1 All ER 275.

³⁴ £65,300 where termination of employment is on or after 1 February 2010.

Finally, although there can be no objection to a senior employee sharing in the rewards of his own efforts, when the price of the company's shares simply reflects an increase in share prices as a whole it might be said that he is simply sharing in everyone else's prosperity. Considerations of this sort have now led to some share option schemes being vetoed by shareholders.

Pension and insurance

As with share options, it is not the practice to set out the details of the employee's pension rights or insurance benefits (e.g. life assurance, permanent health insurance, private health insurance, director's liability insurance, etc) in the service agreement, but simply to state that the employee is entitled to participate in the employer's schemes. It is also recommended that there should be an express right in the service agreement for the employer to withdraw and amend cover and for any rights to insurance benefits being subject to acceptance by the relevant insurers.

Disciplinary and grievance procedures

Good employment practice insists on a properly structured disciplinary and grievance procedure. A short paragraph in a service agreement referring to separate policies and procedures will often suffice. It is also normally recommended that it should be expressly stated in the service agreement that disciplinary policies and procedures are non-contractual.

Summary dismissal and compliance with codes and regulations

Every service agreement, of whatever description, should always include a provision for summary dismissal in the event of dishonesty or gross misconduct. The employee can hardly object to such a term and adequate wording providing on what grounds an employee may be summarily dismissed is standard and often useful particularly in the defence of unfair dismissal claims.

Where codes exist that are relevant to the employment relationship (examples include an internal Code of Conduct, the FSA's Model Code, etc) it is sensible to provide in the service agreement that the employee must comply with them and that a breach of such codes is likely to be viewed by the employer as serious misconduct.

Restrictive covenants, confidentiality and garden leave

Business interests should be protected both during and after employment through well-drafted restrictive covenants and confidentiality provisions.

Although it is common to provide such protection in a service agreement, some employers choose to enter into a separate deed. An express right to place an employee on garden leave should also be included with reference as to what an employee can and can't do during such leave. Restrictive covenants, confidentiality and garden leave are covered in Chapter 7.

Written particulars

Although there is no legal requirement to provide an employee with a written contract of employment, under s 1 of the Employment Rights Act 1996 there is a requirement to provide employees with written particulars of a number of their main terms of employment no later than two months after the commencement of their employment. Sometimes reference will be made in a service agreement to the fact that the employer has complied with such obligation and that the required written particulars are provided in the service agreement and possibly other documents which are referred to.

Other provisions

All service agreements should include clauses dealing with third party rights, governing law and jurisdiction and entire agreement.

The list of provisions provided above is not exclusive and there may be a wide variety of other clauses which need to be inserted into a service agreement before it is accepted by an employee. A senior executive may insist that there is specific reference in the service agreement to reimbursement for payment of membership of a golf club; that his children's private school fees are covered; that relocation expenses are provided for – the list can go on and on.

Although standardising service agreements is preferable in many respects, a service agreement which does not reflect what has been agreed may result in the potential new recruit walking away from negotiations on the basis that there has been a breakdown of trust. For this reason, flexibility is generally recommended particularly when dealing with the recruitment of very senior executives for large organisations.

Special arrangements for overseas employees are dealt with in Chapter 4; holiday, sick pay, maternity and paternity benefits are dealt with in Chapter 5; intellectual property is dealt with in Chapter 6; and directorships are covered in Chapter 8.

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