Settlement Agreements: No 'one size fits all' approach

In light of recent case law, Stephen Ravenscroft and Sarah Taylor discuss the importance of using clear wording when drawing up a settlement agreement

Settlement agreements are a very useful tool for an employer. They normally draw a line under the employment relationship and provide certainty that an employee will not bring any employment- related claims. Such an agreement is often used to reach a full and final settlement of any claims which the employee has or may have arising out of the employment and its termination, subject to certain exceptions such as claims for personal injury or accrued pension rights.

While parties may agree that a settlement agreement will also cover any future claims which an employee does not and could not know about, to do so effectively the terms of the agreement must be absolutely plain and unequivocal. The agreement will also set out what the employee can and cannot do after termination of employment. With every word likely to be scrutinised in the event of a future dispute, the stakes are high and employers and their advisers must be cautious and thorough when drafting such agreements.

Employers must remember that there is no 'standard' settlement agreement. Although an employer may have used the same document for years, employment laws and best practice change over time, and one size rarely fits all. It is therefore vital to make sure that a settlement agreement is tailored to the specific circumstances of an employee's departure.

Not all claims can be settled by means of a settlement agreement or COT3. For example, claims for failure to inform and consult with appropriate representatives on collective redundancies and under the Transfer of Undertakings (Protection of Employment) Regulations 2006 cannot be settled via a settlement agreement (although Acas can conciliate in relation to such claims). Nor is it possible to exclude rights relating to statutory maternity pay (SMP), statutory paternity pay, statutory adoption pay or statutory shared parental pay, as was recently confirmed by the First-tier Tribunal (Tax Chamber) in *Campus Living Villages UK Ltd v Revenue and Customs Commissioners* [2016].

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Watch out for SMP

Ms Sexton was employed by Campus Living Villages as its head of finance and was made redundant while she was pregnant. She claimed unfair dismissal and pregnancy discrimination and her claims were settled under a COT3. As she was still employed by Campus Living within 11 weeks of her expected week of childbirth, Ms Sexton was entitled to receive SMP. Campus Living thought it had dealt with this entitlement to SMP by agreeing to pay her £60,000 in 'full and final settlement of all her claims'. However, Ms Sexton complained to HMRC that she had not received her SMP (worth over £42,000 due to a bonus payment falling within the relevant reference period). HMRC upheld her complaint and stated that she should be paid her SMP separately because it had not been expressly included in the settlement agreement.

This case highlights the importance of specifically referring to the inclusion of any SMP (or any other statutory payment) in a settlement agreement to avoid arguments that it remains payable. In particular, for a settlement agreement to be considered as fulfilling an employer's SMP liability, it must specifically state that any such payment is included to the full extent of the employee's entitlement. This principle will extend to statutory paternity pay, statutory adoption pay and statutory shared parental pay. It is worth noting that an employer may be able to pay SMP in one lump sum (rather than continuing to make weekly payments to employees who have left employment). Employers are also entitled to recover all or most of the SMP from HMRC (employers who paid £45,000 or less in Class 1 National Insurance in the last complete tax year are entitled to recover 100%; all other employers are entitled to recover 92%).

An *ex gratia* payment cannot be considered to meet an employer's liability for a statutory payment. There is an important distinction to make here. An employer is not required to make an *ex gratia* payment (payment without obligation) but does have a statutory obligation to pay SMP (and any other statutory payment). Further, the tax treatment of an *ex gratia* payment is likely to be different to that of a statutory payment. For example, SMP will be subject to income tax and national insurance contributions (NICs). An *ex gratia* payment will only be subject to income tax (and no NICs) on sums over £30,000. It is worth noting that any pre-agreement negotiations will not be sufficient to show that SMP (or any other statutory payment) was taken into account in the calculation of any *ex gratia* payment.

Structure payments carefully

It is important to refer clearly to each limb of any termination payment, not just where an entitlement to SMP arises. Employers and their advisers should pay particular attention to the way in which they structure payment provisions in a settlement agreement or COT3, as the following examples show.

Payment in lieu of notice (PILON)

Where there is a PILON provision in the employment contract, any sums referable to the notice period should be subject to income tax and NICs in the normal way. However, if there has been a clear dismissal of the employee which is in breach of contract (ie a wrongful dismissal), the termination payment may be payable as damages or compensation. In this case, it will be tax free up to £30,000, with no liability for NICs.

Changes to the taxation of termination payments are due to come into force from April 2018, which will remove the distinction between the different tax treatment of contractual and non-contractual PILONs. As a result, any payments referable to the relevant notice period will be subject to income tax and NICs.

Regulatory references

The Financial Conduct Authority and the Prudential Regulatory Authority have confirmed their new and long-awaited rules on regulatory references, which come into effect from 7 March 2017. Under the new rules, firms are required to keep adequate records to produce references for at least six years (excluding serious matters or serious misconduct). If a firm subsequently identifies facts that would have changed the information which it included in a reference, it will be required to update that reference.

These new rules are likely to affect how parties to a settlement agreement agree a form of reference. In particular, employers will need to bear in mind that any agreed form of reference will not override their obligations under the new rules. They will need to provide full and frank disclosure of any information that may come to light following the settlement which would have changed the form of reference provided and update the reference accordingly. The settlement agreement should make provision for this.

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Permanent health insurance

A lump sum payment made by a permanent health insurer in commutation of future benefits may be paid tax free on account of an injury or disability under s406 of the Income Tax (Earnings and Pensions) Act 2003. Employers should consider whether to deduct a separate taxable payment from this lump sum and pay it as, say, a PILON or accrued holiday to protect the favourable tax treatment of the commutation payment.

Injury to feelings

When making a payment for injury to feelings, it will be important to distinguish between discrimination occurring before termination and discrimination arising out of termination of employment. The distinction is important from a tax perspective because any part of a compensation payment that is related to the termination of employment and compensates the employee for financial loss will be taxable (although the first £30,000 of such a payment should be free of income tax). However, compensation for injury to feelings arising out of discrimination suffered during employment that is unrelated to the termination can be paid tax free.

Draft settlements clearly

Employers will want to ensure that any settlement agreement (or COT3) uses both clear and specific wording about the claims that are being settled. *Department for Work and Pensions (DWP) v Brindley* [2016] provides a stark warning about getting this wrong. Mrs Brindley brought a claim for disability discrimination following a final written warning for absence in 2014. This claim was settled in December 2014 via a COT3. The wording of the COT3 covered all claims in that case and:

> *...all other relevant claims arising from the facts of the proceedings up to and including the date [of] this agreement.*

However, before the COT3 was agreed, in November 2014 Mrs. Brindley received a second final warning relating to a different period of absence, which she appealed unsuccessfully in January 2015.

In June 2015, Mrs Brindley brought a new claim in relation to the second warning, and the DWP sought to have that claim struck out on the basis that it was settled by the COT3. The Employment Appeal Tribunal agreed with the employment tribunal that the COT3 did not cover claims arising from the new set of circumstances brought by the second claim. The 'facts of the proceedings' only covered specific matters relating to the first warning, not any action thereafter.

Unpaid awards

Employers have had to pay out more than £83,000 since a new penalty regime for unpaid employment tribunal awards came into force last year. If monies remain unpaid, an employer will be subject to a penalty notice of 50% of the outstanding amount, subject to a £100 minimum and £5,000 maximum. The money is payable to the government, not the employee.

It is a relatively straightforward process for penalties under this new scheme to be issued. The employer will receive a warning notice requiring it to pay the 'relevant sum' within 28 days of the date on the notice. If it fails to make the payment on time, a penalty notice may be issued requiring it to pay a penalty of 50% of the unpaid sum. If the employer pays both the relevant sum and the penalty within 14 days of the penalty notice, the penalty fee is reduced by 50%.

As this case demonstrates, unclear wording in settlement agreements will only fuel problems in the event of a further dispute down the line. Parties will need to identify what it is that they are seeking to achieve when settling claims. Is it particular claims that they are resolving or is there a wider intention? Ideally, the agreement would specify all potential claims. However, simply including a list of every possible employment rights claim was frowned upon by the court in *Hinton v University of East London* [2005], although it does still appear to be effective, provided the list is specific enough. Commonly, an employer will include the most relevant claims in the body of the settlement agreement, with all other possible statutory claims covered in an appendix. It will then ask the employee to warrant that they have raised all applicable claims and are not (and could not reasonably be) aware of any other claims they may have.

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A useful tool but not foolproof

Settlement agreements are a common alternative to going to court to resolve a problem. The attraction is that they usually offer a quicker and less expensive resolution than a drawn-out court process. However, they are not always foolproof.

A well thought out, well-drafted settlement agreement is crucial to providing the outcome an employer wants while protecting it from a court battle. If the agreement is not drafted clearly, confusion can result, which can then lead to litigation that the employer had hoped to avoid in the first place.

Checklist for employers

- Identify what parties are seeking to achieve when entering into the settlement agreement or COT3.
- Use both clear and specific wording about the claims that are being settled.
- Ensure that all limbs of the termination payment are clearly referenced to avoid arguments that certain payments remain unpaid.
- Do not assume that a standard form settlement agreement will suffice.

References/sources

Campus Living Villages UK Ltd v Revenue and Customs Commissioners [2016] UKFTT 738 (TC)

Department for Work and Pensions v Brindley [2016] UKEAT/0123/16/JOJ

Hinton v University of East London [2005] EWCA Civ 532

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