

## Group Briefing

June 2019

# UK EAT concludes that bad leaver provisions were neither unconscionable nor a penalty clause

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This document contains a general summary of developments and is not a complete or definitive statement of the law. Specific legal advice should be obtained where appropriate.

In *Nosworthy v Instinctif Partners Limited*, the UK Employment Appeal Tribunal (the “EAT”) has upheld the enforcement of bad leaver provisions, which required a resigning employee to transfer her shares for minimal consideration and to forfeit her loan notes. The EAT held that the bad leaver provisions, accepted by an employee as part of a share purchase agreement, were not unconscionable and did not amount to a penalty clause.

### BACKGROUND

The claimant, Ms Nosworthy, had been an employee of Communication Operations Limited (“CO Ltd”) prior to its acquisition by Instinctif Partners Limited (“IP Ltd”) in July 2013. As part of the acquisition, IP Ltd required CO Ltd to give equity to key employees in order to incentivise continuity of service, post-acquisition. Accordingly, Ms Nosworthy was given a 2% shareholding in IP Ltd.

The key employees (including Ms Nosworthy) subsequently sold their shares to IP Ltd in a share purchase agreement, under which the employees received both initial and deferred consideration. The deferred consideration included an entitlement to both loan notes and earn-out payments, subject to bad leaver provisions.

The definition of a bad leaver, as set out in IP Ltd’s Articles of Association, included employees who voluntarily

resigned. The associated provisions required bad leavers to forfeit their loan notes and allowed IP Ltd to repurchase their earn-outs at the lesser of acquisition cost or fair value. Moreover, Ms Nosworthy had covenanted, in a Deed of Adherence also dated 26 July 2013, not to become a bad leaver.

When Ms Nosworthy subsequently resigned in May 2016, she challenged the bad leaver provisions by way of claims brought to the UK employment tribunal for (i) breach of contract and (ii) unauthorised deductions from wages (in respect of the forfeiture of loan notes and repurchase of the earn-outs).

### AT FIRST INSTANCE

Ms Nosworthy argued that the bad leaver provisions were unconscionable, breached of the rule against penalties and were contrary to the Modern Slavery Act 2015, since the effect of the

provisions amounted to forced labour. The employment tribunal rejected her claims, save for an element of the unauthorised deduction claim in respect of remuneration that had become payable but had not been paid to her at the correct time.

### ON APPEAL

Ms Nosworthy appealed the employment tribunal's findings that the bad leaver provisions were neither unconscionable nor a penalty clause to the EAT. She also sought to argue, as a new point on appeal, that the bad leaver provisions amounted to an unlawful restraint of trade.

The EAT held that Ms Nosworthy was prohibited from pursuing her claim for unauthorised deductions from her wages, as the applicable UK legislation excludes claims for “*any payment to the worker otherwise than in his capacity as a worker.*” The equivalent Irish legislation, the Payment of Wages Act 1991, also contains this exclusion. The EAT emphasised that the loan notes and earn-outs were deferred consideration for a share sale, and as such were received in Ms Nosworthy's capacity as a vendor of shares rather than as a worker. However, the EAT accepted the employment tribunal's jurisdiction to hear Ms Nosworthy's breach of contract claim, because, under a statutory instrument, the share purchase agreement was “*connected*” with her employment.

The EAT rejected Ms Nosworthy's claim that the bad leaver provisions were unconscionable. In finding that she did not even satisfy the first requirement, the EAT restated the three-part test for setting aside an unconscionable bargain:

- i. one party must have been at a serious

disadvantage, whether as a result of poverty, ignorance, lack of advice or otherwise;

2. the other party must have exploited that advantage in some morally culpable manner; and
3. the resulting transaction must be overreaching and oppressive.

The EAT also concluded that the bad leaver provisions, to which Ms Nosworthy had agreed, made it clear that an employee who voluntarily resigned would be classified as a bad leaver. In circumstances where Ms Nosworthy had warranted in the share purchase agreement that she had obtained legal advice and that the bad leaver provisions were reasonable, the EAT found that no exceptional circumstances existed which would lead it to question whether IP Ltd had been entitled to treat her as a bad leaver.

In relation to Ms Nosworthy's argument that the forfeiture of the loan notes and the repurchase of the earn-outs amounted to a penalty clause that was disproportionate to any loss suffered by IP Ltd as a result of Ms Nosworthy's breach of contract (i.e. the covenant not to become a bad leaver), the EAT concluded that the consequences of being a bad leaver were not dependent on Ms Nosworthy being in breach of contract.

A penalty is a contractual provision, which imposes a detriment on the party in breach of a primary obligation, where that detriment cannot be justified by reference to any legitimate interest of the innocent party in the performance of the primary obligation. Thus a penalty has to operate on a breach of contract. The investment agreement, to which

Ms Nosworthy was a party, contained a covenant that she would not become a bad leaver (as defined in the Articles of Association).

Whilst the EAT acknowledged that Ms Nosworthy had breached the investment agreement, IP Ltd was not relying on this breach to enforce the bad leaver provisions; it was simply applying the standalone rules set out in its Articles. Therefore the issue of penalties was not relevant. The EAT referred to the UK Supreme Court judgment in *Makdessi v Cavendish Square Holdings BV & Anor*, where the Court had confirmed that the rule against penalties was confined to remedies arising from a breach of contract and could not be extended to obligations arising under a contract. (Our update on that decision is available [here](#).)

The EAT declined to hear Ms Nosworthy's new claim that the bad leaver provisions amounted to an unlawful restraint of trade. It held that this claim would require additional findings of fact as to reasonableness and justification, and that circumstances did not exist such as would allow the claim to be raised on appeal.

### CONCLUSIONS

This case demonstrates the parameters of the penalty clause doctrine, as confirmed in *Makdessi*, as being limited to claims based on breach of contract. From an employer's perspective, it also illustrates the importance of recommending that prospective employees obtain independent legal advice as to the consequences of good leaver, and particularly, bad leaver provisions and of ensuring that those provisions are appropriately drafted.

### AUTHORS



**KEVIN LANGFORD**  
PARTNER

+353 1 920 1226  
kevin.langford@arthurcox.com



**DECLAN MACQUILLAN**  
ASSOCIATE

+353 1 920 1308  
declan.macquillan@arthurcox.com



**NIAMH FENNELLY**  
PROFESSIONAL SUPPORT LAWYER

+353 1 920 1392  
niamh.fennelly@arthurcox.com

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**OUR TEAM**

**SEAMUS GIVEN**  
HEAD OF EMPLOYMENT GROUP  
+353 1 920 1210  
seamus.given@arthurcox.com

**KEVIN LANGFORD**  
PARTNER  
+353 1 920 1226  
kevin.langford@arthurcox.com

**CIAN BEECHER**  
PARTNER  
+353 1 920 1193  
cian.beecher@arthurcox.com

**LOUISE O'BYRNE**  
PARTNER  
+353 1 920 1185  
louise.obyrne@arthurcox.com

**DEBORAH DELAHUNT**  
ASSOCIATE  
+353 1 920 1085  
deborah.delahunt@arthurcox.com

**GRACE GANNON**  
ASSOCIATE  
+353 1 920 1077  
grace.gannon@arthurcox.com

**SARAH LAWN**  
ASSOCIATE  
+353 1 920 1769  
sarah.lawn@arthurcox.com

**SALLY DOYLE**  
ASSOCIATE  
+353 1 920 1785  
sally.doyle@arthurcox.com

**NIAMH FENNELLY**  
PROFESSIONAL SUPPORT  
LAWYER  
+353 1 920 1392  
niamh.fennelly@arthurcox.com

**RACHEL BARRY**  
ASSOCIATE  
+353 1 920 1281  
rachel.barry@arthurcox.com

**JOHN CASEY**  
ASSOCIATE  
+353 1 920 1268  
john.casey@arthurcox.com

**SHANE MCCARTHY**  
ASSOCIATE  
+353 1 920 1263  
shane.mccarthy@arthurcox.com

**MAILLE BRADY BATES**  
ASSOCIATE  
+353 1 920 1351  
maillie.brady.bates@arthurcox.com

**SARAH FAULKNER**  
ASSOCIATE  
+353 1 920 1296  
sarah.faulkner@arthurcox.com

**HANNAH O'FARRELL**  
ASSOCIATE  
+353 1 920 1293  
hannah.ofarrell@arthurcox.com

**DECLAN MACQUILLAN**  
ASSOCIATE  
+353 1 920 1308  
declan.macquillan@arthurcox.com

**HELEN WEBB**  
ASSOCIATE  
+353 1 920 2038  
helen.webb@arthurcox.com

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**arthurcox.com**

**Dublin**  
+353 1 920 1000  
dublin@arthurcox.com

**Belfast**  
+44 28 9023 0007  
belfast@arthurcox.com

**London**  
+44 207 832 0200  
london@arthurcox.com

**New York**  
+1 212 782 3294  
newyork@arthurcox.com

**Silicon Valley**  
+1 650 943 2330  
siliconvalley@arthurcox.com