Early termination payments: are they invalid as penalties?

Summary

A recent English High Court decision has provided a useful reminder that the law on penalties does not apply unless a payment is being imposed for a breach of contract. In this case, a football club’s obligation to make a payment to its manager for early termination of his employment contract was found to be valid, and not a penalty. The payment was merely considered as a debt upon termination.

Facts

An English football club recruited a new manager on a fixed term contract of approximately 2½ years' duration. Around a month after the commencement of the contract, the club exercised its contractual right to terminate the employment with immediate effect.

The club sought to resist any obligation to pay an early termination payment. One of the club’s arguments was that the termination clause in the employment contract, which allowed the club to terminate the contract before the end of the fixed term by paying compensation to the manager, was a penalty clause and, as such, was unenforceable. The court decided that the compensation payment was not a penalty and that the clause was valid.

Law

It is common for contracting parties to agree on a specified sum to be paid upon the occurrence of certain events in order to introduce clarity and certainty into arrangements between them. In certain circumstances these types of clauses run the risk of being rejected by a court as a penalty. The law on penalties seeks to prevent the suffering party from recovering a sum that bears little or no relationship to the loss actually suffered as a result of the breach of contract. However, the rule against penalties, as this case shows, applies only where the trigger for payment is a breach of contract. If the trigger is not a breach, but simply the occurrence of an event

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Henning Berg v Blackburn Rovers Football Club and another [2013] EWHC 1070
contemplated by the contract, the clause will not fall under the penalty rule and the sum payable will be considered as a debt.

**Decision**

The High Court examined the wording of the termination clause in the manager’s contract to determine whether the termination of the manager’s employment prior to the expiry of the fixed term constituted a breach of contract. The court decided that:

- The termination was not a breach of contract as it was permitted as of right in the clause: “In the event that the Club shall at any time wish to terminate this Agreement with immediate effect it shall be entitled to do so…”

- The compensation payment was conditional upon the club terminating the manager’s employment before the expiry of the fixed term. The compensation was thus a payment due on the occurrence of an event other than a breach of contract.

The court decided that the law relating to penalty clauses was entirely immaterial and rejected the club’s argument that the termination clause was a disguised or hidden penalty clause.

**Other considerations in assessing whether a payment is a “penalty”**

In considering whether a payment is a “penalty”, besides looking at the trigger for any payment, courts in other cases have also asked whether the sum payable is a “genuine pre-estimate of loss”. A clause may therefore be regarded as a penalty if the sum is obviously and considerably greater than the suffering party's loss.

Balanced against this consideration, courts are generally reluctant to interfere actively under the principle of freedom of contract. Hence in a number of recent UK cases, courts have tried to adopt a broader approach to uphold clauses even if they may not be “genuine pre-estimates of loss”, as long as the inclusion of such clauses is commercially justifiable. In one such case the court decided that even though a clause to increase the rate of interest when a borrower defaulted might not be a genuine pre-estimate of loss, the clause was not held to be penal as the default made the borrower a less good credit risk and on that basis provided a good commercial reason for the increase. It is still unclear how this broader approach of upholding “commercially justifiable” payments will apply in general - the boundary of such an approach has not yet clearly been drawn.
Meaning for Employers

Employment contracts often contain provisions requiring an employee to make certain payments to the employer upon the occurrence of certain events. For example, an employer may require the employee to repay certain amounts paid to the employee, or to forfeit unvested entitlements, if the employee leaves prior to an agreed date, or competes with the employer. Unless properly drafted, such payments may potentially be vulnerable to attack on the basis that they are penalties.

Proper drafting of clauses which seek to impose payments upon the occurrence of particular events other than breach can help reduce the risk of a penalty argument. It may be preferable to avoid describing such non-breach payments as "liquidated damages" (as was used in this case). Damages are usually relevant only where there has been a "breach". In contrast, a payment which is not triggered by a breach is a debt. We suggest that "early termination payment" or "termination compensation" might be better alternatives.

Finally, of course, although the law on penalty clauses in Hong Kong is similar to that of English law, this case is an English High Court decision and, whilst of persuasive value, does not bind Hong Kong courts. It nevertheless reflects the settled law on penalties in Hong Kong.