I owe my soul to the graduate recruitment team: Rethinking penalty clauses in employment contracts

1. Introduction

"You load sixteen tons, what do you get?

Another day older and deeper in debt

St. Peter don't you call me, 'cause I can't go

I owe my soul to the company store."

- *Sixteen Tons*

Tennessee Ernie Ford, 1946

Mr Ford's evocative lyrics refer to the "truck system" that, in the 19th and early 20th centuries, held mineworkers across the UK and US in debt bondage. Their employers paid them not in coin but with tokens, redeemable for food, clothes, and boarding at "company stores".[1] But company stores set inflated prices to ensure mineworkers accumulated substantial debts. To resign, a worker had to pay these debts in full. Because this was practically impossible, truck workers effectively became perpetually indentured servants.[2]

[1] Patrick Atiyah, *The Rise and Fall of Freedom of Contract*, 1979, p534
[2] ***Bristow v City Petroleum*** [1987] 1 WLR 529, 532

The truck system's "*abuses were so flagrant, and its dangers… so imminent*" that it offended even the mores of Dickens' time.[3] Parliament reformed the law by enacting the ***Truck Act 1831***. The Act required payment in coin and not tokens, breaking the monopoly power of company stores to impose inflated debts and thereby deter resignation.

Today, many workers enter multi-year employment contracts that require them to repay introductory training costs before resigning. But some employers overstate the cost of this training, often to implausible sums approaching the employee's annual salary, to make resignation practically impossible. The common law penalty doctrine is the only plausible remedy available and should render such exorbitant stipulated damages unenforceable.[4] But the doctrine is too narrow and too favourable to the enforcing party to be of practical use to most employees, leaving them trapped by inflated debts, often for years.

The time has come to follow the ***Truck Act's*** legislative scheme to its logical conclusion. The reform proposed is to place the penalty rule on a statutory footing, so far as it applies to employment contracts, with enforceable damages limited to the cost of providing training.

[3] Speech of Edward Littleton MP, HC Deb 14 December 1830 vol 1 cc1133-82
[4] As per ***Cleeve Link Ltd v. Bryla [2014] ICR 264 EAT [6]***, employees may rely on the penalty rule before employment tribunals.

2. The Socio-Economic Problem

As our economy becomes increasingly specialised, more jobs require advanced vocational skills like software engineering, data-management, or professional qualifications.[5] Most new employees lack these skills, so many employers provide introductory training at no upfront cost to the employee. But, to guarantee their investment, the employee agrees to repay the cost of their training if they resign before their multi-year contract expires. Call the generic model of this agreement a "training contract".

Mutual benefit explains the popularity of training contracts across industries like airlines, corporate law, and software engineering. The employer benefits from skilled employees, security of investment, and a guaranteed term of service. The employee benefits from training in marketable skills, entry into a professional role, and correspondingly enhanced earning power, which in turn should make repayment of training debts affordable if they choose to resign.

More broadly, by incentivising employers to invest in their employees, these agreements tend towards a more skilled and productive national workforce.[6] Training contracts achieve this without state intervention or public expenditure, as is currently required to

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[5] World Economic Forum, *'Strategies for the New Economy: Skills as the Currency of the Labour Market'* (2019), p4

[6] The macro-economic value of exchanging training or professional skills for a guaranteed term of service is long recognised. The model is cited, for example, as being key to persuading artisans to travel to the American colonies and thereby leading to their rapid economic growth (Lawrence James, *The Illustrated Rise And Fall Of The British Empire* (1999)).

incentivise employers to take on apprentices.[7] Training contracts also improve social mobility. Highly paid jobs tend to be highly skilled, and the cost of self-funding the necessary training for professional roles is particularly insurmountable for low-income applicants.[8]

The problem is that a number of employers who provide in-house training, including large organisations that hire “many thousands” of graduates, overstate the cost of providing their training many times beyond any reasonable market valuation.[9] These debts often approach or exceed the employee’s annual salary.[10] This creates a mismatch between the employee’s earning power and the debt, because the employee develops more limited skills than their employer is charging them for. Practically, this has the effect of making repayment, and thereby resignation, practically impossible for most employees.

The overstatement of training costs in order to deter resignation is a serious socio-economic problem for three reasons. Firstly, employees who cannot resign are particularly open to abuse and exploitation. They have no recourse if they are denied advancement opportunities, given low quality work, refused pay rises, or treated

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7 UK Education and Skills Funding Agency, *‘Traineeships: framework for delivery 2021 to 2022’*, 13 August 2021

8 For example, most commercial law firms pay for LPC fees and offer cost of living grants to their future trainees, which totals to approximately £25,000 in assistance for London based students (https://targetjobs.co.uk/careers-advice/law/which-law-firms-will-fund-your-lpc-and-gdl-course-fees-and-pay)

9 The Good Law Project, *‘New crowdfunding campaign, Amsterdam, and Vote Leave’* (18 June 2018) <https://goodlawproject.org/news/new-crowdfunding-campaign-amsterdam-vote-leave-newsletter/> accessed 07 October 2021

10 ***Ofonagoro v Sparta Global Ltd***, 2305008/2019, [27]

poorly.[11] The issue also disproportionately affects already disadvantaged BME and working-class employees, who are more likely to enter these contracts.[12]

Secondly, the agreements are substantively unfair because they do not reflect the employee's intentions. When employees agree to substantial debt liabilities, they do so in exchange for a particular quality of training which they believe justifies that obligation and will, by enhancing their earning power, make it repayable. When employers deliberately overstate the cost of training, they impose an obligation which the employee did not necessarily intend to accept.

Finally, overstated costs discredit the training contract model.[13] If overstated costs continue to be prevalent, applicants will be more hesitant to accept jobs with high value, high liability training, because they cannot be sure it is accurately priced and therefore worth the liability. To protect themselves, they will tend towards jobs with less valuable training, because smaller and more manageable liabilities are less risky. This means the training contract model will be less effective at providing high quality training and improving workforce productivity.

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[11] Indeed, short of the employer's behaviour amounting to discrimination or otherwise meeting the high test for a finding of constructive dismissal by breach of the implied term of trust and confidence (***Mahmud & Malik v BCCI [2000] AC 20, [43 D-E]***), the employer can lawfully subject employees to quite unpleasant conditions.

[12] The Chief Executive of the Social Mobility Commission argues that overstated training contract debts are "likely to have a disproportionate impact on disadvantaged young people starting their early careers. First generation graduates don't always have the knowledge and confidence to recognise when an opportunity may not be what it seems." Quoted in GraduateFog, *'Deep concern' over exit fees, says Social Mobility Foundation',* <https://graduatefog.co.uk/2021/6627/deep-concern-over-exit-fees-says-social-mobility-foundation/>, June 28 2021, accessed 07 October 2021.

[13] See George A. Akerlof, *'The Market For "Lemons": Quality Uncertainty And The Market Mechanism'* (1970) 84 The Quarterly Journal of Economics., for analogous market failures caused by informational asymmetry. Here, the employer is the seller, the employee is the buyer, and the product is the training provided.

The common law penalty doctrine is the obvious and only plausible legal remedy for employees burdened by overstated liabilities.[14] Unfortunately, as I now turn to show, the current penalty rule is too narrow to be an effective remedy.[15]

3. The current penalty rule

Contracting parties may agree that on breach a defaulting party must pay the other party a specified sum, in lieu of court determined compensatory damages.[16] Call this a "stipulated damages clause". Stipulated damages clauses are commercially useful because they enable contracting parties to better calculate the allocation of risk[17] and save the court time in determining quantum.[18] They also allow for certainty in damages, particularly where the nature of loss will be difficult for a court to quantify.[19]

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[14] One might think the restraint of trade doctrine is a plausible alternative remedy. But the doctrine only applies to agreements which restrict the employee's conduct after the contract is terminated (***Warner Brothers Pictures, Inc v Nelson*** [1937] 1 KB 209, p214). The clauses discussed here do not restrict post-contract conduct in substance or form. For example, after resigning, it would not be a breach for the employee to work for a new employer while repaying their debt or indeed being delinquent in payment.

[15] The authors of the IDS Employment Law Handbook (Vol. 3, 2019, para 7.25) suggest the reformulated penalty doctrine may have been intended to apply only to agreements between parties of "comparable bargaining power", and therefore not to employment relationships. But this seems unlikely, because the judgment applied equally to ***ParkingEye***, which concerned a consumer contract made on standard terms and so was not an agreement between parties of comparable bargaining power. It would also be irrational for the court to deny employees a potential remedy to unfair contracts, given they are much more likely to suffer unfair obligations. Indeed, the Scottish Law Commission agrees that ***Cavendish*** applies equally to employment contracts (*Discussion Paper on Penalty Clauses*, 2016, para 5.13)

[16] Law Commission, Penalty Clauses and Forfeiture of Monies Paid (Working Paper no 61, 1975) para 6

[17] ***Philips Hong Kong Ltd v. The Attorney General of Hong Kong Co (Hong Kong)*** [1993] UKPC 3a [54-55]

[18] ***Robophone Facilities v Blank*** [1996] 1 WLR 1428, p.1447

[19] ***Cavendish Square Holding BV v Talal El Makdessi / ParkingEye Ltd v Beavis*** [2015] UKSC 67**,** [249]

The courts have long retained a power to render exorbitant stipulated damages clauses unenforceable through the penalty doctrine.[20] The penalty doctrine distinguishes between “Liquidated Damages Clauses”, which are enforceable stipulated damages clauses, and “Penalty Clauses”, which are unenforceable. This distinction is fundamental to the modern law.[21]

The Supreme Court revisited the penalty clause doctrine for the first time in a century[22] in ***Cavendish Square Holding BV v Talal El Makdessi***, heard jointly with ***ParkingEye Ltd v Beavis***. The former concerned an individually negotiated contract between two legally advised commercial parties, the latter concerned the standard terms offered by a parking garage to a consumer.

The grammar of the doctrine is set out by Lords Neuberger and Sumption:

> “The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.”[23]

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[20] The source of this power is shrouded in mystery, such that the UK Supreme Court and the High Court of Australia offered sharply divergent histories of the doctrine, in ***Cavendish*** and ***Andrews v ANZ Banking Group Ltd [2012] HCA 30*** respectively.
[21] Law Commission (n16) para 7
[22] The last occasion being ***Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd*** [1914] UKHL 1
[23] ***Cavendish*** (n19) [32]. Alternative but similar versions of the test were also put forward by Lord Mance [143] and Lord Hodge [255]. But only the test put forward by Lord Sumption and Lord Neuberger commanded majority support among the justices (from Lord Clarke and Lord Carnwath). This test is also frequently cited as the authoritative version: ***Hayfin v Windermere*** [2016] EWHC 782 (Ch) [133], ***Cargill International Trading Pte Ltd v Uttam Galva Steels Ltd*** [2019] EWHC 476 (Comm) [37].

Assuming the impugned provision is a secondary obligation, the courts should therefore apply a two stage analysis. Firstly, the court weighs the legitimate interest of the innocent party in preventing breach. Secondly, given the weight of that legitimate interest, the court applies a loose proportionality test to determine if the damages stipulated are exorbitant.

4. Why the Penalty Rule is Too Narrow

The reformulated penalty rule is too narrow and too favourable to the enforcing party to be an effective remedy to trapped employees, in two ways. Firstly, the identifiable legitimate interest is plausibly very broad. Secondly, the proportionality test is loose. As I will show by means of a case study, the legal effect is that even very onerous stipulated damages clauses will be deemed enforceable.

4.1 The plausible scope of the legitimate interest is too broad

The enforcing party must have a legitimate interest in the performance of the primary obligation protected by the stipulated damages clause. But understanding what is meant by a legitimate interest presents a "major difficulty".[24] The problem is that a very wide set of commercial considerations can plausibly form part of the legitimate interest.

[24] William Day, 'Disproportionate penalties in Commercial Contracts', in *Contents of Commercial Contracts: Terms Affecting Freedoms* (1st ed, Hart Publishing, p212)

ParkingEye demonstrates the potential breadth of a legitimate interest. In that case, the charge of £85 for briefly overstaying at a parking garage was not a penalty, despite the virtually nil loss to the parking garage caused by a single customer overstaying.[25] The reason was that ParkingEye's profitability depended on customers generally not overstaying so that it could quickly turnover spaces.[26] The legitimate interest protected by the stipulated damages clause was their entire business model, because that model depended on customers adhering to the rules.[27]

Additionally, the court found that the innocent party's legitimate interest could even include the interests of third parties. Part of the legitimate interest protected was that of ParkingEye's landlord, the adjacent shopping mall owner, because an efficient parking scheme was important to their tenant retailers, and therefore to their rental income.[28]

The problem with the court's willingness to recognise such weighty legitimate interests is that, on a proportionality approach, they presumably justify very high stipulated damages.[29] Practically, the Cavendish approach thereby narrows the applicability of the penalty doctrine to only the most extreme examples.

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[25] ***Cavendish*** (n19) [99]
[26] Ibid
[27] Similarly, in ***Dunlop*** (n22), the legitimate interest protected by a clause that prevented discounted resale of the innocent party's branded goods was their entire business model, because discounted resale threatened "the disorganization of their trading system and the consequent injury to their trade in many directions.", p.92
[28] ***Cavendish*** (n19), [99]
[29] Another example which I cannot detail here is ***Gray v Braid Group*** [2016] CSIH 68, in which a contractual "bad-leaver" provision protected the plausible legitimate interest of preventing the entire company's collapse.

4.2 A detriment will rarely be out of all proportion to a legitimate interest

The Supreme Court's proportionality test is intentionally "loose".[30] The stipulated damages must be not merely disproportionate to the value of the legitimate interest protected, but "out of all proportion"[31], "exorbitant"[32], or "unconscionable"[33].This narrows the range of damages which can be deemed unenforceable.[34]

The rationale for a loose test, as Lord Woolf put it, is "*The fact that two parties, who should be well capable of protecting their respective commercial interests, agreed the allegedly penal provision suggests that the formula for calculating liquidated damages is unlikely to be oppressive*."[35] Thus, the court affords the enforcing party a "*generous margin"* of appreciation when assessing proportionality.[36]

The problem with this rationale underpinning the loose proportionality test is that it does not apply to consumer contracts like that of ***ParkingEye***, or to employment contracts, because both are ordinarily agreed by parties with unequal bargaining power.[37] Yet the loose test applies to such contracts all the same. The rule's rationale and its legal effect are thus incoherent.

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[30] Roger Halson, *Liquidated Damages and Penalty Clauses*, (1st edn, OUP 2018), para 2.48
[31] ***Cavendish*** (n19) [32]
[32] Ibid [133]
[33] Ibid [249]
[34] William Day (n24), p211
[35] ***Philips Hong Kong Ltd*** (n17)
[36] ***Murray v Leisureplay*** [2005] EWCA Civ 963, [43]
[37] Jonathan Morgan, *Great Debates In Contract Law* (2nd edn, 2015), p217

It follows from the court's approach that the nature of the relationship between the contracting parties has very limited influence over the courts assessment.[38] The court will "*not consider that oppression on a party to make a contract is of itself a criterion in determining whether a contractual sum is a penalty*".[39] This makes sense, given the test provided by Lords Neuberger and Sumption is entirely focussed on the consequences of agreements and not the procedure by which agreements are made.

4.3 The Cavendish Test Applied: Case Study

In this section, I apply the ***Cavendish*** test as sketched above to ***Ofonagoro v Sparta Global Ltd***,[40] one of only two cases involving a graduate litigating against their employer over training contract penalty clauses, to demonstrate the doctrine's narrow applicability.[41] This is a particularly instructive case study because numerous companies, together employing thousands of graduates, have similar business models and use similar contracts to the defendant employer.[42]

In ***Ofonagoro***, the claimant was a recent graduate employed by the defendant software engineering company. The company's business model was to train graduates as engineers, and then lease them to SME's as on-site IT consultants on a multi-year basis. The defendant provided a three-month course in basic software engineering that

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[38] ***Cavendish*** (n19) [34-35]
[39] ***Murray v Leisureplay*** (n36), [49]
[40] Employment Tribunal, 2305008/2019/V
[41] The other being ***Bennett and Day v Geeks Ltd***, a first instance ET decision in which the provision was found not to be a penalty. ***Ofonagoro*** went undefended and was first-instance, so is not an authoritative statement of the law. It is the factual circumstances of the case that are of interest.
[42] Robert Wright, Financial Times, *'When employment contracts come with exit fees'* <https://www.ft.com/content/0164135c-0cfa-4efe-a78b-c2d0e8bdf937> Accessed 08 October 2021

was mostly self-learning but partly tutored by unqualified instructors.[43] The claimant agreed to repay £22,000 for this course if he resigned within two years, just shy of the claimant's £23,000 annual salary.

As per the court's finding of fact, it is highly implausible that the course cost £22,000.[44] In comparison, the most highly regarded and intensive software engineering courses in London cost students £8,000 for 16 weeks.[45] The largely self-taught and elementary 12-week course offered by the defendant can therefore be reasonably valued at substantially less than £8,000.

Turning to the penalty test, there are three plausible elements to the employer's legitimate interest in the employee not resigning. Firstly, the stipulated damages clause directly protects the employer's investment in the employee's training, even if that investment is much smaller than the damages stipulated.

Secondly, the employer is protecting their entire business model, which rests on consultants being leased for guaranteed terms to clients. If employees resign early, this could diminish the perceived value of their services and harm the employer's relationships with clients.

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[43] ***Ofonagoro*** (n40) , [8]
[44] ***Ofonagoro*** (n40), [27]
[45] Makers, 'How much does the course cost?'<https://faq.makers.tech/en/knowledge/about-the-makers-course/practicalities/how-much-does-the-course-cost> accessed 9 October 2021

Finally, the host client's interest can be identified as part of the legitimate interest, because they presumably benefit more from an IT consultant that has a certain term, that spends years learning the needs and processes of their organisation, and has had time to develop working relationships among staff.[46]

The employer's plausible legitimate interest in the employee not resigning is clearly very broad. As explained above, the fact that this is an employment relationship will barely influence this assessment. It therefore seems unlikely, or at least highly uncertain, that the £22,000 stipulated damages would be found "out of all proportion" to the legitimate interest protected, in this or thousands of similar potential cases, despite it approaching the employee's salary and wildly overstating the cost of providing training. The conclusion we can draw from the case study is that the narrow penalty doctrine provides no practical remedy to employees facing overstated liabilities.

[46] The substantial cost of training new employees is well documented: Training Magazine, "2019 Training Industry Report." <https://trainingmag.com/sites/default/files/2019_industry_report.pdf> Accessed 10 October 2021

5. The proposed reform

Thus, only law reform can provide a remedy to trapped employees. This essay proposes inserting the following provision after Section 15 of the ***Employment Rights Act 1996*** (on the right not to have to make payments to employer):

Section 15A Right not to have to repay unreasonable training costs to employer

(1) A liability imposed on a worker, wholly or in part intended to recoup the cost of providing training, may not exceed the lesser of

(a) a reasonable valuation of the cost of providing that training; or

(b) the total of the costs detailed in the "schedule of training costs".

(2) In determining a reasonable valuation of the cost of providing training, the court will have particular regard to:

(a) The market rate for the training or comparable training;

(b) The quality of the training provided; and

(c) Whether the training is as described in the schedule of training costs

(3) Employers will provide workers with a schedule of training costs, separately itemising the cost of providing teaching, learning materials, and supervision.

(a) The schedule will be provided and brought to the attention of prospective workers before contracting.

(b) The schedule will be made reasonably accessible to the worker at their request during their term of service.

(c) No detriment will be imposed on a worker for requesting their schedule.

(4) An employer that fails to comply with subsection (3) with respect to a liability imposed on a worker may not enforce that liability.

5.1 The Reasonable Valuation

This reform ties the value of stipulated damages to a reasonable valuation of the cost of providing training. This strikes a fairer balance, because it enables employers to recoup their investment in employees, while ensuring employees avoid liabilities substantially exceeding the value of their training.

The reasonability requirement adds flexibility, and admittedly unpredictability, to the remedy. But flexibility is necessary, because not all forms of training will be amenable to precise market valuation. Employers, particularly those in more niche industries, will require some margin of appreciation in costing and delivering training.[47] But the unpredictability is mitigated by stipulating the factors the court must take into account in assessing reasonability.

The statute does not apply to stipulated damages clauses which do not intend to recoup the cost of training. This allows employers to maintain provisions like bad-leaver clauses, which serve a practical and commercial purpose distinct from recouping training costs.[48]

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[47] Judges already make reasonability assessments with regard to consumer contract terms under the ***Unfair Contract Terms Act 1977***, so the reasonability of training contracts is amenable to judicial scrutiny.

[48] See for example ***Gray v Braid*** (n29). Whether the current penalty rule is a desirable way of regulating these clauses is beyond the scope of this essay.

5.2 The Schedule of Training Costs

Currently, employees are not entitled to any information about how their training costs are calculated. The schedule of training costs allows the employee to more easily determine whether they are being overcharged. They can, for example, independently consider the market prices of their learning materials and compare that with the schedule. This has three benefits.

Firstly, it will allow employees to better determine whether they can successfully litigate, making their rights practically useful. Because the reform provides a broadly predictable test, the employee will have a strong chance of predicting their true liability. This gives them more agency, because they can resign with confidence that their liabilities will not be overwhelming.

Secondly, increased transparency regarding the quality and cost of training will help prospective employees identify firms which do not overcharge. Candidates can be more confident taking on high value, high liability training, because they are at less risk of being overcharged. This transparency will enhance the credibility of the training contract model, preparing employment law well for an economy which will increasingly rely on training contracts. It will also encourage employers to charge more reasonable sums, because better candidates will avoid unjustifiably onerous obligations.

Finally, by making the employee's choice more informed, the debt liability of employees in fair contracts is better justified. Employees in reasonably priced training contracts will still have to pay to resign, but in practice this bargain no different to simply paying for a training course on credit.

Practically, a schedule of costs is not an onerous positive obligation on the employer, given some employers already volitively provide them.[49] This obligation echoes Part I of the ***Employment Rights Act 1996***, which imposes a number of positive obligations to provide documents like itemised pay statements.

Additionally, subsection (4) requires compliance with subsection (3) to make a liability enforceable. This incentivises employers to self-regulate, avoiding perennial difficulties with state enforcement of employment laws.[50]

6. Conclusion

This essay proposed a statutory remedy to overstated stipulated damages clauses which is practical, desirable, and useful. The remedy is practical, because it offers a predictable remedy to employees and incentivises employers to self-regulate. It is desirable, because it remedies a legal status quo that encourages unfair agreements, exposes employees to exploitation, and threatens a model that boosts national productivity. Finally, it is useful, because it prepares employment law for an increasingly

[49] For example, the defendant employer in ***Geeks Ltd*** (n41) did so.
[50] Hugh Collins, K. D Ewing and Aileen McColgan, Labour Law (2nd edn, 2019) pp41-43

specialised economy, where training contracts will dominate the graduate employment landscape.

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