

## Termination of key management personnel: Judicial stand and practical considerations

### Introduction

Under the Indian legal regime, there is no specific legislation which governs the employer-employee relationship. As such the relationship between them is purely based on terms which have evolved from industry practices and customs, such as probation period before confirmation of employment, termination by notice or payment in lieu thereof etc. By having varied standards and no regulated set principles governing employment contracts, save for the basic provisions applicable under the Indian Contract Act, 1872, there is ambiguity in the mind of the employer and the employee vis-à-vis the legality and sanctity of the terms included under the employment contract. The decision to terminate becomes a challenge and quite tricky for the employer while wading through the maze of subjectivity leading to termination.

Termination of employment may occur due to several reasons which can broadly be categorized into external and employee related factors. External factors would include change in market conditions, organizational restructuring, inability to pay dues and related factors which have a bearing on the capability of the employer to stay afloat. Employee related factors usually encompass lack of performance, breach of the employment terms, misconduct, inefficiency, or simply loss of confidence by the employer in the employee. The concerns that plague employers are the repercussions of termination and potential action for damages by the employee. The present newsletter discusses the evolved contractual provisions dealing with termination of employment, the Indian judicial principles and certain practical insights on the termination provision.

### 1.0 The Two Sets of Causes

The options of an employer for termination of employment can be narrowed down to two sets of causes, being either employee centric or unrelated factors. Though both causes have the same end result, the manner in which the termination is brought about differs significantly, and, therefore, merit separate consideration. The following paragraphs discuss the two set of causes for terminating key personnel by an employer.

#### 1.1 Termination attributable to the employee

*Breach of employment contract:* An employer is entitled to terminate on grounds of breach when the employee is required to act in a certain manner by the employer or by the nature of the job, and fails to do so. This assumes greater significance when key personnel fail to adhere to the terms of their employment contract, and/or directions of management as there is a certain level of expectation that is attached to their appointment. Usually, the job description underlines the expectation of the employer that the employee will perform

his/her duties appropriate to their designation. It is also common practice to include performance of express or implied directions in the job description as it may not be possible to include all performance parameters required of the employee.

A simple example illustrating breach is where a person is appointed as the managing director with the intent of supervising the operation and growth of the organization, and the employment contract placed a requirement on the employee to discharge duties appropriate to those of a managing director, among others. During the course of employment, the person does not act in accordance with the directions of the Board, as is required of a managing director by law,<sup>1</sup> and the expectation of the employer expressed under the contract. If the employee fails to deliver, the employer can accordingly hold the person in breach of the employment contract, and terminate his/her employment.

*Termination on account of inefficiency:* Another common cause leading to severance of employer-employee relationship is inefficiency and lack of performance. This is a just and equitable ground for termination since it is not reasonable to expect the employer to keep a person employed where the employee fails to perform consistently. However, before the employer terminates the employment, it must collate enough material and information so that it can, at a later stage, counter any allegations by the aggrieved employee of foul play.

Additionally, it is pertinent to note most employment contracts do not provide for termination of employment on account of lack or performance. This may be due to the fact that in particular cases it is not possible to provide the basic level of performance required, and also in certain instance, the employer may not be comfortable with providing a lower limit to the performance required of an employee, thereby making the employee reluctant to perform efficiently and improving productivity. To avoid a situation where the employee does not have any performance obligation, it is advisable to provide performance standards briefly under the job-description at the time of appointment and prescribing standards in the HR policy.

*Misconduct, leading to termination:* The most common ground for termination is usually misconduct. This ground has also been the subject of litigation as under termination for misconduct a certain level of stigma is attached. It is essential for employers to either define precisely what will amount to misconduct or to have an exhaustive uniform HR policy which will describe inclusive instances of how an employee can be removed for misconduct.

The term *misconduct* implies an outright breach of duty or obligation arising under the employment contract or the human resource policy or wrongful behavior. In practice, common examples of actions, or inactions, which are included in HR policy under the term *misconduct* are - reporting late to work, unauthorized absence from work, negligence in performing duties/work, willful insubordination and not following instructions of the management or supervisor. In some situations, misconduct may also be categorized into minor misconduct and grave misconduct. Usually a process is defined in the context of minor misconduct which, typically, includes warning the concerned individual and where

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<sup>1</sup> The Companies Act, 1956 prescribes that a managing director shall act in accordance with and under the supervision and guidance of the Board.

there is no improvement despite a certain number of warnings, escalating the matter to the management level or provide pecuniary penalties. With regard to grave misconduct, the usual practice is to provide the concerned employee with a show-cause notice to justify his/her reasons for the misconduct, and where the reasons forwarded are not acceptable; termination. An employer has to ensure that due process is followed before termination.

## 1.2 Termination driven by market conditions

The reasons attributable solely to an employer for terminating the employment can be external, necessitating scaling back of operations and reduction of headcount. As mentioned above, such reasons primarily include market recession or economic slow-down and organizational restructuring. Usually, most employment contracts provide for termination for convenience. In this context, the contractual provision often used stipulates “30 day notice or pay in lieu thereof” wherein the employer either gives the employee a notice stating that the employment will stand terminated after 30 days, or gives the employee 30 days salary in lieu of the notice wherein the employment stands terminated with immediate effect.

Another mode of termination is providing the Voluntary Retirement Scheme (“VRS”) to its employees. VRS is compulsorily applicable to public sector companies or government companies. While it is not mandatory for private limited companies to provide such schemes where they are cutting back on employees, this mode is utilized mostly where the employee that needs to be terminated is a part of the top management. This mode is a golden-handshake, where the employer gives its employees the option to take a lump-sum and opt to leave the employer voluntarily and is a good option where the employer faces economic constraints and yet wants to part with the employee on amicable terms. Usually, the departing employee will probably join the same industry.

## 2.0 Important considerations

In order to ensure that termination is not bitter, or acrimonious, or leads to protracted legal disputes the employer and employee must try to insert specific grounds for termination in the employment contract. In certain cases, the employer has been held liable to pay compensation, solely on the basis of a sentence under the contract. For example, in *Avineshwar Sawbney v. J. K. Industries Limited*<sup>2</sup> the employer had terminated the employment. The employment contract provided that the employee was hired for a period of five years, and the termination would be carried on grounds of misconduct and breach.

A separate clause under the employment contract provided that “*the company shall not ordinarily terminate the services of the employee during the continuance of the agreed tenure of five years except for the reasons mentioned in Clause 4 above, but if it becomes necessary to dispense with the services of the employee, the Company shall give three months’ notice or pay in lieu thereof to the employee and the Company shall not claim any refund of the amount which it has spent on travel and training.*” The employee was hired in 1975 for a period of five years. The employment was terminated in 1977 and the

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<sup>2</sup> 2008 (152) DLT 712.

employee sued the employer and sought arrears of salary from 1977 till 1981 for wrongful termination.

The lower court held the employer could terminate the employment; however, the appellate court reversed the decision and held the termination wrongful. The primary contention of employee, accepted by the court, was that the clause provided that the employer shall not ordinarily terminate the employment. The court had further held that termination of the employee can indeed be carried out on subjective considerations; however, the subjective considerations must be based on objective facts. This case has been discussed further ahead. It is, therefore, pertinent that the employer very carefully considers the provisions under the contract, and factors in judicial precedents, before proceeding to terminate.

### 3.0 Judicial stand in India on termination of employment

As is clear from the foregoing, under the Indian legal regime, the basis on which the employer-employee relationship is governed is purely contractual and based upon judicial precedents. The legal principles governing the relationship have evolved from various judicial decisions and the courts have categorized termination into two categories, (a) termination *simpliciter* and (b) termination for misconduct.<sup>3</sup>

While the courts have not defined “misconduct”, the Supreme Court has held that termination of an employee whether *simpliciter* or punitive has to be decided on the facts and circumstances of each case. In one such case<sup>4</sup>, the Supreme Court has examined instances where termination is *simpliciter* or on account of misconduct i.e. punitive. One of the judicially evolved tests to determine whether an order of termination is punitive is to evaluate whether prior to the termination there was: (a) a full-scale formal enquiry, (b) into allegations involving moral turpitude or misconduct which, (c) culminated in a finding of guilt. If all three factors are present, the termination is held to be punitive irrespective of the form of the termination order. Conversely, if **any one** of the three factors is missing, the termination has been upheld.

In India, termination of employment on grounds of misconduct is treated as a punitive action as a certain level of stigma is attached to such a termination. Where an employee is terminated for misconduct, it casts aspersions on the capability of the individual to contribute to the employer and also impacts on future employment with other employers. Courts in India have a tendency of leaning in favor of employees, and where it feels the employer has removed an employee as a punitive measure, it has set-aside the termination as unreasonable. Frequent communications from the employer to the employee informing him of his shortcomings, lack of performance and unsuitability have worked in the employer’s favor in justifying termination and avoiding long drawn litigation by the employee.

Additionally, courts in India have held that the reasons for termination of employment must have objective considerations, i.e. must be based on facts which can be

<sup>3</sup> Mathew P. Thomas v. Kerala State Civil Supply Corporation Limited and Others; AIR 2003 SC 1789.

<sup>4</sup> Pavanendra Narayan Verma v. Sanjay Gandhi PGI of Medical Sciences (2002) 1 SCC 520.

proved by documentation or evidence. In *Avineshwar Sawhney's* case,<sup>5</sup> the employer had terminated the employment of a person on account of inefficiency and loss of confidence by the management. The lower court upheld the termination order after recording the testimony of the management witness and held that the subjective satisfaction of the employer was sufficient to cause termination. However, on appeal, the lower court's decision was overruled by the appellate court on the basis that the subjective satisfaction of the employer for termination has to be based on objective considerations. The burden lies on the employer to show and place on record the necessary documentary evidence. The abovementioned case relied upon the Supreme Court decision in the case of *L. Michael and another v. M/s. Johnson Pumps Ltd*,<sup>6</sup> and is still valid law.

## Conclusion

In conclusion, it is amply clear that the contractual provisions primarily govern the employment and its termination. In the absence of specific employment laws, an aggrieved person may seek judicial remedies, and courts decide whether the termination has been carried out in accordance with the contractual terms. Most importantly, while considering the termination the employer must have evidence, documentary or otherwise, to support the reasons for removal of an employee from gainful employment. It is also important that the employer remains in constant touch with the employee, and communicate its expectation(s) to the employee. This will primarily help the employee understand what is required of him/her, and avoid a situation where the employer decides to let go of the employee. Additionally, this will also serve the purpose where the employer decides to terminate employment by justifying the termination and also reducing the possibility of the employee feeling aggrieved and initiating litigation.

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<sup>5</sup> *Avineshwar Sawhney v. J. K. Industries*, 2008 (152) DLT 712. followed in *A. N. Shukul v. Phillips India and Ors*, Delhi High Court decided on September 7, 2009.

<sup>6</sup> 1975 AIR (SC) 661, 1975 (1) SCC 574, 1975 SCC (L&S) 169.