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Separation Agreements (Employment) (India)

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A Practice Note setting out the key considerations and legal issues when an employer is entering into a separation agreement with an employee on termination of employment in India, including drafting guidance for the separation agreement.

An employer may decide to terminate employment in India and want to enter into an agreement with the affected employee(s). There are a number of important legal issues that arise when entering into such an agreement. This Note provides an overview of the key aspects of a mutual separation agreement in India. It considers:

- The form and scope of settlement.
- Any statutory obligations in relation to the mutual separation agreement.
- The timing of when the mutual separation agreement should be provided to employees.
- The admissibility of pre-agreement negotiations and whether they are legally binding.
- The common provisions which should be included in the mutual separation agreement, including possible issues surrounding the separation date and garden leave.
- Payments, including any mandatory payments required.
- The inclusion of restrictive covenants.
- The execution formalities for mutual separation agreements.

Form of Settlement

In India, mutual termination is often achieved by executing a mutual separation agreement between the parties. A mutual separation agreement records a mutual termination of employment and a waiver and release of claims (in consideration of an ex gratia payment). The mutual separation agreement also typically contains the post-termination obligations of the outgoing employee towards the employer for example, non-disclosure of confidential information, non-disparagement, and so on.

Some employers use a waiver and release of claims letter instead of a more formal mutual separation agreement. As such, there are no specific legal requirements for mutual separation agreements in India and these agreements remain largely untested in Indian courts.

Scope of Settlement

The parties' statutory rights (for example, payment of wages and gratuity under law) cannot be waived contractually. Various judicial pronouncements have established that no person can waive any of their statutory rights unless both the following conditions are satisfied:

- The parties have a direct private benefit from the right sought to be waived.
- The conferred right does not pertain to any matter involving public interest.

Any provision in an agreement is also void if it either:

- Restricts a party absolutely from enforcing their rights under or regarding any contract or limits the time within which the party may enforce their rights.
- Discharges any party from any contractual liability on the expiry of a specified period to restrict any party from enforcing its rights.

(Section 28, Indian Contract Act, 1972.)

Therefore, while a waiver of statutory claims is commonly included in separation documents as a deterrent, such a provision is not enforceable.

Employment-related disputes covered by the Industrial Disputes Act, 1947, can be resolved by conciliation, arbitration, or litigation. Other terms of employment related to post-separation confidentiality obligations and non-solicit obligations, among other things, are contractual obligations in nature that can be addressed by parties in a mutual separation agreement.

There are no statutory requirements in relation to claims or disputes that must be expressly addressed in the mutual separation agreement.

Timing

Mutual separation agreements remain largely untested in Indian courts, given that employee resignations (at the behest of the employee) and employment terminations (at the behest of the employer) are the common forms of employment separations. Therefore, there are no specific legal requirements pertaining to mutual separation agreements. The process is largely driven by market practice.

A copy of the proposed mutual separation agreement is typically provided to the employee as part of the employer's separation discussions with them.

Pre-Agreement Negotiations

Pre-Agreement Negotiations: Documents and Communications Used as Evidence

The common law concepts of "settlement privilege" and "without prejudice" on documentation and communications are generally recognised under the Indian Evidence Act, 1897 (Indian Evidence Act), in relation to civil disputes. Section 23 of the Indian Evidence Act protects admissions from being made in court if the parties expressly agreed against that disclosure. However, the relevant provisions do not apply directly to proceedings before industrial tribunals and labour courts, which are the relevant bodies in relation to employment matters.

There are cases where Indian courts observed that offers and counteroffers made to resolve disputes amicably are generally without prejudice to the rights and contentions of the parties. However, there is not enough jurisprudence on this subject, especially regarding separation negotiations and related settlement terms.

Pre-Agreement Negotiations: Legally Binding?

Pre-separation agreement negotiations are not legally binding, until confirmed as binding in the mutual separation agreement.

Separation Agreement: Subject to Contract and Without Prejudice

The concepts of subject to contract and without prejudice are generally recognised in the context of the Indian civil law of evidence, but the agreement need not state that it is subject to contract and without prejudice. This is because mutual separation agreements in India are typically executed after separation negotiations between the parties have concluded. Employment separation-related negotiations with employees typically take place verbally but are then finalised with the execution of a written mutual separation agreement.

Mutual Separation Agreements

The agreement should avoid using the term "termination," as a mutual separation agreement is structured as an amicable separation between the parties and not an "employment termination" by the employer under Indian labour laws (which is a unilateral termination of employment by the employer). It is recommended to use terms, such as "separation," "employment cessation/separation date," and "separation payment" instead of terms, such as "termination," "termination date," and "termination payment." Incorrect usage of these terms may lead to different legal implications (see, for example, Payments).

Parties

In India, there is no legal requirement regarding what information about the parties must be included in a mutual separation agreement. However, as a matter of practice and to avoid ambiguity, agreements typically contain certain identifying information about the parties, including:

- Names.
- Addresses.
- Taxpayer permanent account numbers (PAN) for individuals and corporate identity numbers (CIN) for companies.

Separation Date

Employment may end either on the date of execution of the mutual separation agreement or on a date agreed on by the parties in the agreement, which can be on any date before the expiry of the contractual notice period. In this event, the employee is paid in lieu of the unexpired notice period. This is required under Indian federal and state labour statutes, regardless of whether it is provided for in the terms of employment. It may also be mutually agreed that the employee will serve the entire notice period.

Garden Leave

The employee can be placed on garden leave during the notice period or before the employment cessation date or both, which is common practice (see Separation Date). The Bombay High Court has clarified that garden leave provisions can only apply to a period preceding the termination of employment and not after termination (*VFS Global Services Private Limited v Mr. Suprit Roy 2008 (2) BomCR 446*).

If the employee is placed on garden leave and the mutual separation agreement is executed before the employment cessation date, the employee's obligations during the garden leave period should be reiterated in the mutual separation agreement.

The terms of the garden leave can be agreed on in the mutual separation agreement regardless of whether it was provided for in the terms of employment. It is, however, common practice in India to include a garden leave clause in an employment agreement (especially for mid- or senior-level employees).

Under various state-specific shops and establishments acts (applicable to commercial establishments) and the Factories Act, 1948 (applicable to manufacturing units and factories), an employee accrues annual leave that is to be used at their discretion. As a result, the employer cannot set off any unused annual leave against the employee's notice period or garden leave period, or both, except at the employee's request.

Payments

Ex Gratia Severance or Retrenchment Compensation

Where an employee is retrenched (that is, terminated by the employer), they are entitled to severance or retrenchment compensation calculated at the rate of 15-days' pay for every year of service over six months if:

- They are categorised as a workman under Indian labour laws (that is, not an employee engaged in managerial and administrative capacities or in a supervisory capacity drawing a monthly salary exceeding INR10,000).
- They have been employed for at least a period of 240 days.

(Section 25F, Industrial Disputes Act, 1947.)

Because a mutual separation is an amicable separation related to a resignation (and accordingly not a retrenchment under Indian labour laws), this retrenchment compensation is not payable in the case of mutual separations. However, to achieve an amicable separation, it is common practice to factor an amount mirroring the statutory severance payment into an ex gratia payment to the employee under the mutual separation agreement.

The ex gratia amount varies depending on multiple factors (including the type of industry, nature of work performed by the employee, years of service, and past practices followed by the employer). The market practice is generally to offer one-month's pay for every completed year of service (while a terminated workman is entitled to only 15 days per year of service).

It is recommended to separately reference the ex-gratia payment in the mutual separation agreement, given that the ex gratia amount (which exceeds the statutory payments) is usually offered to incentivise the employee to separate amicably and as consideration of the employee agreeing to abide by the obligations set out in the mutual separation agreement. Some employers also provide a detailed breakdown of the separation payments to the employee (including the full and final settlement amounts and ex gratia amounts) in an annex to the mutual separation agreement to document having made such payments.

Other Payments

In addition to an ex gratia payment, other separation payments include:

- Payment in lieu of notice (which is factored into the ex gratia amount in cases where the employee separates with immediate effect).
- Any contractual bonus or arrears.
- Payment against encashment of unused and accumulated annual leave, as applicable.
- Gratuity.

The Payment of Gratuity Act, 1972 applies to employers with at least ten employees. Employees who have completed at least five years of continuous service are entitled to a gratuity payment of 15 days' wages for every year of service or part thereof in excess of six months (section 4, Payment of Gratuity Act, 1972). Gratuity can be capped at INR2 million.

Amounts Payable to Employee: Termination with or Without Cause

No-cause terminations in India are not permissible. At-will employment is not recognised in India and therefore employment termination can only be with cause or on account of misconduct.

Payments on termination depend on whether the termination is for misconduct or other reasons. Where termination is for:

- Reasons other than misconduct, certain payments are triggered, such as:
  - severance or retrenchment compensation of 15-days' pay for every year of service exceeding six months (for workman category individuals continuously in service for at least 240 days);
  - payment in lieu of notice (minimum one month);

  - gratuity (if the employee has completed at least five years of continuous service);
  - leave encashment; and
  - any other payments owed under the contract.
- Misconduct, there is no need to pay severance or retrenchment compensation and payment in lieu of notice, but the other types of payment listed above are typically applicable. However, if the employee is terminated for certain prescribed acts of misconduct, the gratuity may be forfeited by the employer. Under some state laws, and subject to the employment contract, notice requirements may also not be payable.

Payments Made to Employee on Separation: Taxation

Retrenchment compensation up to INR5 lakhs paid to a workman on separation of employment is not subject to income tax deducted at source under the Income Tax Act (see Payments). However, all other compensation payable on termination and mutual separation (including the ex-gratia payment) is treated as "profits in lieu of salary," which is considered taxable income. Contractual payments received on separation also attracts tax liability. Gratuity of up to INR 20 lakhs paid to an employee on separation is exempt from taxation under the Income Tax Act. Leave encashment of up to INR 25 lakhs paid to an employee at the time of retirement is exempt from taxation.

There is no legal requirement to specifically state that taxes are payable against the separation payments. However, for clarity, employers typically include a statement that separation payments are subject to tax withholding.

Time Limits on Payments: Wages

Section 5(2) of the Payment of Wages Act, 1936 (POWA), states that where a person's employment is terminated by or on behalf of the employer, the "wages" earned by the employee must be paid before the expiry of the second working day after employment is terminated. However, the applicability of the POWA to commercial establishments varies between different states.

An employer may assert that a mutual separation is not technically an employment termination by the employer and therefore should not trigger this obligation under the POWA. However, the employer must still comply with requirements for the timing of payment of all wages as defined widely under the POWA to include "any remuneration payable under any award or settlement between the parties." Employers must generally pay wages within:

- Seven days after the wage cycle (for employers with up to 1,000 employees).
- Ten days after the wage cycle (for employers with 1,000 or more employees).

(Section 5, POWA.)

However, the Code of Wages, 2019 (Wage Code), which has been notified in the official gazette but not yet made effective, subsumes the POWA once effective. Under the Wage Code, payments of wages where the employee has resigned from employment must be made within two days from the date of separation. This is to also cover mutual separations, as they are not treated separately under Indian law.

Time Limits on Payments: Gratuity Payments

Gratuity payments must be paid to an eligible employee within 30 days from the date of termination (section 7(3), Payment of Gratuity Act, 1972).

Time Limits on Payments: State-Specific Requirements

State-specific shops and establishments acts (which apply to commercial establishments located in certain Indian states) may also provide a time limit within which wage and payments on termination must be made to employees. For example, under the shops and establishments acts applicable in some Indian states, payment of wages representing the employee's untaken leave must be made within two days after termination of employment.

References

It is not common to include a mutually agreed reference in the mutual separation agreement.

However, employees are typically issued an experience or service certificate that they can submit to prospective employers, which serves as a confirmation that the individual was employed with the organisation and typically includes the dates of hire, date of separation, and the employee's designation at the time of separation.

In some cases, the issuance of a service certificate is a statutory requirement, depending on the laws applicable to the employer. For example, the Model Standing Orders framed under the Industrial Employment (Standing Orders) Act, 1946, which applies to factories and commercial establishments in some states, requires the employer to issue a service certificate to outgoing employees. Whether this requirement applies is determined based on:

- The nature of the establishment or industry.
- The number of workmen.
- The state in which the establishment is located.

Return of Company Property

A mutual separation agreement should ideally include a clause providing for the employee to:

- Return any property belonging to the company before the separation date.
- Delete any information relating to the business and its contacts within the employee's possession.

A separation agreement should also include a clause enabling the employer to deduct the cost of any damaged or unreturned company property.

Confidentiality

The confidentiality clause in mutual separation agreements typically reiterates the existing obligations contained in the employment agreement or the proprietary information, or both, and any inventions assignment agreement, executed by the employee at the time of commencement of employment.

Employers should ensure that the agreement clearly defines the information to be protected as confidential information, to the extent feasible and reasonable in terms of its coverage.

Restrictive Covenants

Restrictive covenants can be included in mutual separation agreements. Although post-termination non-compete clauses are commonly included in mutual separation agreements, these clauses are generally not enforceable, as they are considered a "restraint of trade" under Indian contract law principles (*Percept D'Mark (India) Pvt. Ltd. v Zaheer Khan & Anr. AIR 2006 SC 3426*).

The only exception to this rule is that someone selling goodwill of a business may agree with the buyer to refrain from operating a similar business "within specified local limits," provided that these limits are deemed reasonable by the court in consideration of the nature of the business.

The validity of restrictive covenants is generally determined based on the standards of reasonability, in consideration of duration and geographical limits of the restriction at issue. In India, courts tend to adopt interpretations favorable to employees to protect their rights, given the heavy bargaining power of employers.

Separability or Severability

Separability clauses are commonly incorporated within mutual separation agreements, to avoid the entire agreement being held void or unenforceable due to the illegality, invalidity, or unenforceability of a part of the agreement.

Execution Formalities

Under the Indian Stamp Act, 1899, and state-specific stamp duty enactments, any "instrument" (which includes an agreement) that confers a right or creates an obligation must be stamped at or before signing. Stamping of the document essentially indicates payment of a small amount of duty to the government.

An instrument that is un-stamped or under-stamped (with an insufficient payment) may not be admissible as evidence in a court. At that stage, the court may re-direct the parties to adjudicate the document (that is, calculate the stamp duty and penalty on it), which may significantly delay enforcement.

In certain Indian states, intentional non-stamping is a criminal offence.

Stamping may be done by:

- Purchasing stamp paper of the requisite denomination and printing the document on the stamp paper.
- Franking of the document at local designated banks.
- Purchasing an electronic stamp (only in certain Indian states).

The stamp duty amount is calculated based on the type of the agreement, the covenants in the agreement, and the applicable state stamping regulations. The state-specific schedule containing prescribed stamp duties for general agreements should be consulted when determining the stamp duty for mutual separation agreements.

Signing

The mutual separation agreement must be signed by both the employer and the employee. An authorised representative empowered to act on behalf of the employer, either by power of attorney or board resolution, can execute the agreement on the employer's behalf. Although it is advisable for evidentiary purposes to have a contract attested by witnesses (typically one or two), there is no legal requirement for witness signatures. The agreement may be signed either manually or using an electronic signature.

Language

The agreement can be executed in English or the local language if both parties understand the terms of the agreement.

Filing

There is no requirement to notify or file, mutual separation agreements with any government authorities, as they are typically treated as voluntary resignations (not retrenchments).

Other Common Terms

Mutual separation agreements typically reiterate post-separation obligations contained in the employment contract or in standalone agreements (such as a proprietary information and inventions assignment agreement), including obligations of:

- Non-solicitation
- Non-disparagement including non-disparagement on social media.
- Non-disclosure of confidential information of the employer.

A mutual separation agreement may also include a clause stating that the employee cannot assign the rights and obligations under the mutual separation agreement.