UK Unfair Dismissal Reform: Key Implications for Private Equity Sponsors

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The UK government's reforms to unfair dismissal rights represent a potentially significant shift in employment risk allocation for employers and investors alike.

Currently, employees with two years' continuous service have the right not to be unfairly dismissed. In broad terms, for a dismissal to be fair, the employer must establish one of the potentially fair reasons for dismissal set out in statute (namely capability/poor performance, misconduct, redundancy, statutory illegality or some other substantial reason) and must also follow a fair procedure in carrying out the dismissal. Typically, for example, a fair procedure for a performance-related reason might take six months or more before a fair dismissal could be implemented.

At present, compensation for ordinary unfair dismissal claims is subject to a statutory cap (currently the lower of one year's gross pay or (approximately) £125,000). While senior employees may sometimes seek to frame disputes as discrimination or whistleblowing claims (where compensation is uncapped), the existence of the unfair dismissal cap has nonetheless helped to maintain a relatively predictable level of exposure in termination scenarios and operated as a key reference point in negotiating executive exits and settlement packages (particularly where, as is often the case in executive departures from private equity-owned businesses, no prior performance procedures are being followed). This often enables disputes to be resolved within reasonably defined parameters and executives to be exited through the use of severance agreements in relatively short timescales.

Reforms. From 1 January 2027:

- The statutory cap on unfair dismissal compensation will be removed entirely.
- The qualifying service period for bringing ordinary unfair dismissal claims will be reduced from two years to six months.

The result is a significant expansion in both who can claim and how much they can recover. Unfair dismissal compensation may, at least in principle, extend to a wider

range of remuneration-related losses, including lost bonus, share schemes, LTIPs, MIP and/or carried interest entitlements.

Why This Matters for Private Equity Sponsors. The reforms are likely to have implications extending beyond HR and legal teams, including for transaction structuring, diligence, pricing, operational oversight and exit planning, particularly in people-heavy or restructuring-driven strategies.

The removal of the compensation cap materially increases potential liability per claim. The current statutory cap has historically provided a degree of commercial certainty in executive terminations, particularly where no formal processes are being followed. Its removal weakens a key benchmark used in settlement discussions, increasing unpredictability around termination costs and potentially shifting the negotiation dynamics in favour of the departing executive.

At present, on a typical departure of a UK-based executive, the severance package will be determined by two key factors, namely the notice period (typically six or 12 months) (where typically a payment in lieu of notice would be paid) and an additional severance payment as an incentive for the executive to enter into a severance agreement. Where the executive is highly paid, that additional severance payment would effectively have a maximum equal to the unfair dismissal cap (assuming that the executive has no basis to make claims where there is no cap, such as discrimination or whistleblowing claims). Following the removal of the cap, it is likely that negotiations on that additional severance element will shift to focus more heavily on issues such as how long the executive is expected to incur financial loss, what should be encompassed within the scope of that loss, what steps the executive has taken (or should reasonably be expected to take) to mitigate their loss and whether compensation should be reduced on the basis that dismissal would have occurred in any event following a fair process and/or to reflect any contributory conduct by the executive.

In our view, the reforms may also create additional uncertainty in relation to management incentive arrangements. It would be typical for such incentive arrangement rules to provide that the departing executive would, on a termination without cause, lose (or have repurchased for nominal cost) any unvested entitlements. Typically, incentive arrangements would also provide that the executive would have no rights to compensation for any lost incentive rights. While unfair dismissal compensation is already potentially broad in scope, the existing statutory cap has historically limited the practical significance of claims relating to forfeited incentive entitlements. The removal of the cap may increase scrutiny of whether losses connected to forfeited incentive rights could form part of an unfair dismissal compensatory award, although the extent to which such claims are legally viable remains largely untested in caselaw at present. If such claims are possible, this could undermine the structuring of

typical leaver provisions in such management incentive arrangements. In addition, typical incentive plan rules providing that the departing executive has no rights to compensation for lost incentive rights may not be effective to prevent unfair dismissal claims in respect of such rights.

Up until now, UK tribunals have rarely had to grapple with assessments of such losses, mainly because the existence of the compensation cap has meant that such issues do not often arise in practice. This is now likely to change, and tribunals may need to assess difficult questions as to how the loss of such management incentive rights should be valued, if indeed such claims are possible. For example, if an incentive right would have only paid out on an exit by the private equity sponsor, the tribunal may need to consider the possible valuation on an exit (particularly where, as at a tribunal hearing date, no such exit has yet occurred) and how uncertainties relating to the timing of a possible exit should be reflected in compensation reductions. This in turn is likely to be reflected in more contentious severance negotiations with departing executives.

The reduction in the length of qualifying service for unfair dismissal from two years to six months also complicates senior management changes in a portfolio company on or following acquisition. At present, any departures of executives with less than two years' service can generally be implemented relatively easily with little or no procedure applicable and no severance (other than notice period/payment in lieu) required. Following the changes in January 2027, the category of executives who can be exited in that way will shrink significantly. The reduction in the length of qualifying service is also likely to lead to a greater emphasis on and use of probation periods and associated procedures in the initial six months of any new executive hire's employment.

Early Considerations for Sponsors and Portfolio Companies. While we are yet to see what the judicial interpretation of such reforms will be (particularly whether unfair dismissal damages in respect of lost incentive rights are possible and how tribunals would assess such financial loss), sponsors and portfolio companies may wish to begin considering preparatory steps now.

- **Increase Scrutiny of Termination Processes:** While the reality is that ordinary employee termination processes are not always commercially appropriate for use in the context of senior executives, post-reform, employers are likely to face greater scrutiny regarding the procedural fairness of dismissals, even in cases involving relatively short-serving employees. More rigorous performance management, documentation and internal process discipline may therefore become increasingly important.

- **Reassess Employment Risk in Diligence and Portfolio Oversight:** Sponsors may wish to revisit how employment risk is assessed within diligence processes and

portfolio oversight frameworks, particularly in relation to businesses that are workforce-heavy, restructuring-driven or reliant on management incentive arrangements.

- **Consider Contractual Mitigants:** Portfolio companies may explore amendments to employment contracts, incentive documentation and leaver provisions aimed at mitigating potential exposure. However, the ultimate effectiveness of such measures remains highly uncertain (particularly given that unfair dismissal legislation has strict controls around any attempts to contract out of rights to claim unfair dismissal) and is likely to be tested through future litigation.

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Please do not hesitate to contact us with any questions.

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