Debenhams & Carluccio's - meaning of adoption of employment contracts in administration

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Case: Re Carluccio's Limited (in administration) [2020] EWHC 886 (Ch), Snowden J, 13 April 2020 and Re Debenhams Retail Limited (in administration) [2020] EWHC 921 (Ch), Trower J, 17 April 2020 and [2020] EWCA Civ 600, 6 May 2020

Synopsis: In giving guidance to administrators on the use of the Coronavirus Job Retention Scheme for furloughed employees, the courts, in particular the Court of Appeal in Debenhams, have clarified the approach to adoption of employment contracts for the purposes of para 99 Sched B1 IA 1986.

Topics covered: Administration; adoption of employment contracts; administrator's powers

Comment

The decisions in Carluccio's Limited and in Debenhams Retail Limited (at first instance and in the CA) considered the inter-play between the Coronavirus Job Retention Scheme (the Scheme) and insolvency legislation and case law. Beyond the immediate guidance the decisions provide on the use of the Scheme by administrators, both cases clarify aspects of the decision in Powdrill v Watson (Paramount Airways Limited) [1995] 2 A.C 394 on the interpretation of, and the general principles regarding, adoption of employment contracts in administration for the purposes of para 99 Sched B1 IA 1986. In particular, the cases confirm that mere continuation of an employment contract (without more) does not, of itself, amount to adoption. The Debenhams CA decision will now become the leading case on this topic.

On the application of the Scheme in administration, the courts considered on what basis administrators could cause the company to apply for a grant under the Scheme and then make payment direct to furloughed employees. By accessing the Scheme, or making payments, would the employment contracts of furloughed employees be adopted? At the time of the decisions, broad guidance had been issued on the Scheme, but no detailed legislation or regulations had been introduced. Both Snowden J and Trower J (in the respective High Court decisions) were also concerned whether it was appropriate to give directions at all: no representative employee had been joined, and any directions at law would not be binding. The court could only give directions that the administrators be at liberty to act in a particular way, without prejudice to the ability of an interested party to argue subsequently that its views were wrong. Both recognised however that the Covid-19 pandemic was a critical situation, and that it was "right that, wherever possible, the courts should work constructively together with the insolvency profession to implement the Government's unprecedented response to the crisis in a similarly innovative manner."

These decisions did not answer all outstanding questions with regard to how the Scheme applies in administration. There remained a concern that wages in excess of the Scheme amounts (where the employees had not agreed to reduce pay to the amounts available under the Scheme) may be a super-priority claim in the administration, similarly in the case of certain other liabilities, such as accrued holiday pay and employer's NICs on that pay.

The Scheme:

The Coronavirus Job Retention Scheme (the Scheme) was first announced by the Chancellor of the Exchequer on 20 March 2020, with the first on-line guidance published on 26 March 2020. At the time of the decisions no detailed legislation had been introduced.

In essence, the Scheme was addressed to employers in businesses affected by the COVID-19 pandemic, enabling them to furlough employees, with a view to their retention, and apply for a grant covering 80% of affected employees' usual monthly wage costs, up to £2500 a month, plus associated employer NICS and pension contributions on the furlough pay. It was a condition of accessing the Scheme that the relevant employees should provide no work or services to the employer during the period of furlough, and that the decision to furlough should be confirmed in writing to employees. Payments received under the Scheme were payable to the employer and would be treated as income of the employer for tax purposes. The guidance noted that the Scheme was available to companies in administration, subject to the expectation that the Scheme would only be accessed if there was a reasonable likelihood of the employees resuming work for the company, for example on a sale of the business in the administration.

The Facts - Carluccio's

S108 Housing Grants, Construction and Regeneration Act 1996 confers a right upon a party to a All the company's restaurants were closed on 16 March 2020 in line with Government advice in response to the Coronavirus pandemic. An administration order was subsequently made on 30 March 2020, with a view to a sale of the business and a better realisation than in liquidation. With a view to achieving that purpose, the administrators wished to retain the employees and claim under the Scheme. Shortly after their appointment, the administrators wrote to all employees proposed to be furloughed, offering to retain them on varied terms, in particular that for the furlough period their pay would be reduced to the amount available under the Scheme , and the reduced wages would only be paid if and when the grant was received. Affected employees were asked to agree to the terms of the letter. Of the 1,788 affected employees, the vast majority accepted its terms, 4 had requested redundancy and a few more had not responded.

The administrators sought directions from the court; the judge summarising the main issues as (1) how the administrators could lawfully give effect to the furlough arrangements with employees who had expressly accepted the varied contract terms and (2) whether the administrators would be able to avoid incurring liabilities by adoption (for the purposes of para 99(5) Sched B1 of IA 1986) of the unvaried contracts of those employees who had not accepted the varied terms, where they might otherwise feel compelled to make those employees redundant before the end of the first 14 days of the administration.

The Decision - Carluccio's

Although it appeared the Scheme was intended to be available to companies in administration, it was not clear from the Scheme guidance then available how administrators would be entitled to pay furloughed employees consistently with insolvency legislation. There had to be a mechanism found under that legislation to justify the administrators paying the furloughed employees in priority to other claims against the company. In the judge's view, the only realistic candidates were paras 99 and 66 Sched B1 IA 1986. Whilst para 66 was drafted in very wide terms, and had proven "useful" in previous cases, it was clear to the judge that para 99 was the provision specifically designed to deal with the ability and obligation of administrators to pay wages in an administration.

The judge went on to consider the key concepts of adoption for the purposes of para 99 in Lord Browne-Wilkinson's judgment in Powdrill v Watson (Paramount Airways Limited) [1995] 2 A.C 394:

- The starting point was that the appointment of an administrator does not terminate a contract of employment, and the "mere failure" by the company in administration to

terminate does not automatically mean the contract has been adopted. This can still be the case after expiry of the 14 day period following appointment of the administrators (see Re Antal International Limited [2003] 2 BCLC 406).

- The “critical part” of the analysis in Paramount was that “adoption…can only connote some conduct by the administrator…which amounts to an election to treat the continued contract of employment…as giving rise to a separate [prior ranking] liability in the administration…”

- In the “normal situation”, that conduct is likely to be a communication to the employee that he or she should come to work in the usual way: the administrator’s conduct “objectively signifies a willingness” to pay wages as a priority payment.

Applying these principles to the Carluccio's employees (excluding those few who had opted for redundancy whose position was clear):

(a) The Consenting Employees (i.e. those who had responded positively to the varied terms) were now employed on those varied furloughed terms, as per their acceptance of the letter: this had occurred before the expiry of 14 days and nothing done at that stage could amount to adoption of the varied contract. It was however clear to the judge that, as and when the administrators made an application under the Scheme or made any payment to these employees, that would amount to adoption of the varied contracts: the administrators would be doing an act which “could only be explicable on the basis that they were electing to treat the varied contract as giving rise to liabilities qualifying for super-priority”. Accordingly, this would enable super-priority payment to be made to furloughed employees under para 99(5) using grant monies as and when received under the Scheme (or from other funds of the company which would then be reimbursed when monies under the Scheme were received).

(b) The non-responding employees might not have expressly accepted the offer prior to the expiry of 14 days into the administration. In that event, and if nothing else happened, the administrators would not be treated as having adopted the unvaried contracts by the mere failure to terminate prior to the expiry of the 14 day period. The employees were not able to attend for work and there would be nothing done or said by the administrators which could amount to an election to treat the unvaried contracts as giving rise to super-priority liabilities. The employees would continue to be employed, but would have an unsecured claim. Those employees could however belatedly choose to accept the furlough terms; they would then fall to be treated as consenting employees and their contract would be adopted in the same way.

In light of the judge’s conclusions in relation to para 99, he did not express any concluded views on the potential applicability of para 66 to the situation before him. He did however comment that para 66 might be an appropriate way in which the administrators could fill any gaps or deal on an ad hoc basis with any particular issues of detail that might arise in relation to implementing the Scheme.

The Facts – Debenhams

Debenhams, which had some 15,550 employees, closed its stores following the introduction of lockdown measures. From 25 March 2020 the company wrote to approximately 13,860 employees informing them that they were being placed on furlough under the Scheme. On 9 April 2020, Debenhams entered into administration. The administrators decided that express consent from the employees should be sought, and wrote to all or most of the furloughed employees seeking

their consent to being furloughed and to the consequent reduction in pay. By the time of the hearing express consent had been received from just over 12,700 employees.

The administrators sought directions whether the employment contracts of furloughed employees would be adopted by the administrators (within the meaning of para 99(5) Sched B1) if the employees remained furloughed and the administrators took no further action in relation to them except to pay to them amounts received or reimbursed under the Scheme.
Notwithstanding the significant consents to the furloughing arrangements received by employees, the administrators remained concerned because there was no clarity on the treatment of sick pay and holiday pay under the Scheme. Both those categories qualified for super priority as wages and salary for the purposes of para 99, but it was not at that stage clear how they would be taken into account when quantifying the capped 80% eligible for the Scheme grant.

The Decision - Debenhams – first instance

The administrators challenged the correctness of Snowden J's conclusion in Carluccio's that making an application under the Scheme in respect of consenting employees or making payments under the varied contracts would amount to adopting them: They argued that Snowden J had been wrong to reach the conclusion that the administrators would thereby be doing an act "only explicable" on the basis that they were electing to treat the varied contract as giving rise to liabilities qualifying for super-priority. They also argued that he had misunderstood the inter-relationship between paras 66 and 99: there was no reason why payments to employees could not be justified under para 66, and it was not necessary to invoke para 99 to do so.

Trower J agreed that it was clear from Paramount that for adoption to take place it was necessary to identify some positive step by the administrators which causes the relevant contract to be continued. The court held that by (i) causing the company to make an application under the Scheme and (ii) making payment to the furloughed employees, the administrators would be engaging in positive conduct which presupposed that the contracts of those employees continued to exist.

That formulation of the test was slightly different from that adopted by Snowden J in Carluccio's, but this would not lead to a different result. The court held that what mattered was whether there was a separate liability arising in the administration which had arisen out of elective conduct by the administrators, not whether they subjectively wanted that liability to have a particular ranking.

The Decision - Debenhams - Court of Appeal

The CA rejected the administrators' appeal, David Richards LJ giving the judgment of the court.

The administrators argued that, on the true ratio of Paramount, before it could be concluded that contracts of employment had been adopted, there must be demonstrated (i) words or conduct on the part of the administrators (ii) which, objectively construed, evidenced an election on the part of the administrator; (iii) to treat the liabilities arising under the contract of employment as enjoying super-priority.

The court noted that this would involve a test of what the administrator can be taken to have wished or agreed, in other words, an objective assessment of the administrator's state of mind, judged by his or her words and conduct. In the CA's view, that argument misunderstood the

approach taken in Paramount. When that decision referred to "some conduct by the administrator …. which amounts to an election to treat the continued contract of employment as giving rise" to super-priority, it was not introducing as a relevant factor the intentions of the administrator, even if objectively determined. It did not require the conduct of the administrator to evidence an election by the administrator. Instead, it was a question of law: was the conduct of the administrator such that he or she must be taken to have accepted that the relevant amounts falling due under the employment contract enjoyed super-priority? It was a wholly objective question, focussed entirely on the conduct of the administrator. The essence of the test was that if the office-holder has taken active steps to continue workers' employment, that necessarily results in super-priority for the relevant liabilities under the contracts of employment. By contrast, doing nothing involves no continuation by the administrators of the employment.

Whether the administrators had continued the employment of the furloughed employees was to be decided by reference to the evidence before the court. In the present case, the CA was satisfied that the administrators had clearly adopted the contracts of the furloughed employees.

The CA did however agree with the Debenhams' administrators that para 66 was an appropriate and perhaps the most obvious source of authority for payments to be made to furloughed employees. The condition for payments under that paragraph, that the steps taken would be "likely to assist achievement of the purpose of administration", would necessarily be satisfied. In contrast, by its terms, para 99 operates only where a person ceases to be the administrator. Whilst the court agreed with Snowden J's conclusion that on the proper construction of para 99 the administrators had adopted the relevant Carluccio's employee contracts, it did not accept that in reaching this conclusion Snowden J relied upon para 99 as the authority for the payment of remuneration under the Scheme. There was therefore no material conflict between the two cases.

The court noted the difficulties that administrators may face in deciding whether to take the steps necessary to retain furloughed employees, or to place employees on furlough. It could see that there might be good reasons of policy for excluding actions restricted to implementation of the Scheme from the scope of "adoption" under para 99, but such exclusion could not be accommodated under the law as it stood.

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