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Court of Appeal Holds Administrators Will Be Taken to "Adopt" Furloughed Employees' Contracts if They Take Advantage of UK Coronavirus Job Retention Scheme

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At A Glance

In the first Court of Appeal case on the UK's Coronavirus Job Retention Scheme ("the Scheme"), the court held that Debenhams' joint administrators would be taken to adopt furloughed employees' contracts if the administrators claimed under the Scheme or continued to pay employees.

This means relevant employees' wages/salary (together with certain other amounts such as sick pay and holiday pay) for the post-adoption period will have a super-priority status in the administration.

The decision potentially has major ramifications for the conduct of administrations where employees are furloughed, given the super-priority ranking afforded to contracts adopted by administrators. The decision risks undermining the policy objectives behind the Scheme, in that it may prompt administrators to make greater numbers of employees redundant at the outset of an administration, unless employees expressly consent to reduce wages/salary to amounts covered by the Scheme.

Decision

The Court of Appeal held, in its judgment of 6 May[1], that contracts of employees furloughed prior to the appointment of administrators to Debenhams Retail Limited ("the Company") would be treated as "adopted"[2] in circumstances where the administrators:

- caused the Company to pay the employees; or
- made an application in respect of the employees under the Scheme,

beyond the initial "safe" period of 14 days post-appointment.

Debenhams' case quickly follows that of Carluccio's[3], covered in our previous Alert — the first English case in the context of furloughed employees. *Carluccio's* confirmed that the Scheme is available to a company in administration and provided related directions as to the variation and adoption of affected employment contracts.[4] Debenhams' case differed from Carluccio's in certain important respects, including that Debenhams' employees had already been furloughed prior to the commencement of the administration.

Rationale

- **Non-provision of services is not decisive:** Although furloughed employees were not carrying out any work for the Company (and indeed are not permitted to do so under the terms of the Scheme), the enforced non-provision of services is not decisive for the question of adoption. Citing *Carluccio's*, the Court identified other relevant factors, e.g., that the company continued to benefit from covenants restricting employees undertaking other work, and that the employee would continue to be available to a prospective purchaser of the business.
- **Company not merely a "conduit":** Although in economic terms the Company acts as a conduit for payment of Government funds to employees (i.e., the effect on the administration is neutral), legally the furloughed employees remain employed. The remuneration is an expense of the Company and the government grants are income of the Company. The Government could have devised a furlough scheme which did not involve using the employer as the conduit for the remuneration, but it did not do so.
- **Employment contracts continue pending any decision to terminate:** The furloughed employees' contracts remain in existence unless terminated. Essentially, employment contracts cannot be put in the "deep freeze" as a matter of law — they either continue, or are terminated.

Impact and Comment

Following this judgment, stakeholders should assume that the test for "adoption" will necessarily be satisfied if administrators take advantage of the Scheme. Accordingly, relevant liabilities under employment contracts will be entitled to super-priority ranking in the administration estate.

The intended effect of the Scheme is (essentially) to delay the point at which a decision needs to be made as regards redundancies and provide an interim measure of support through the grant system to preserve the employed status of the workers[5]. The Court of Appeal's decision risks undermining this goal, owing to the risk and uncertainty for administrators as to the quantum of super-priority claims represented by:

1. the "20% shortfall" payable to employees who do not expressly consent to reduce earnings to the 80% to be reimbursed under the Scheme (capped at £2,500 per month);
2. pay in respect of holiday taken during the furlough period (if employees claim that should be paid at 100% of their pay and not just the 80% covered by the Scheme); and
3. holiday accrued post-adoption but not taken and where employees are subsequently made redundant during the administration (where employees would have an entitlement to be paid out in full for those days, with the administrators arguably unable to make any recovery of those amounts under the Scheme).

The Court of Appeal expressly acknowledged that "there may be good reasons of policy for excluding action restricted to implementation of the Scheme from the scope of "adoption"…, but such exclusion cannot be accommodated under the law as it stands".

It is possible the Government may amend the Scheme such that employees neither take nor accrue holiday whilst furloughed. Clarifying this would solve for amounts described at 2. and 3. above — and administrators may elect to terminate employment contracts of non-consenting employees, which would solve for amounts in 1. above.

Background

The Company, its "light touch" administration and its furlough arrangements

The majority of the Company's employees — c.13,000 store-based employees, of a total of c.15,550 employees — were furloughed on 25 March, prior to the Company's entry into administration on 9 April. The purpose of the administration is to seek to rescue the Company as a going concern.

The "light touch" administration — **the first in the current market** — involves providing consent to the Company's management continuing to exercise certain operational powers, with the aim of resuming trading from stores again once the Coronavirus restrictions are lifted.

The administrators were concerned at the extent of the exposure represented by the 20% shortfall between the 80% of wages/salary to be reimbursed under the Scheme (subject to the £2,500 cap per employee) and the full liabilities under the employment contracts (potentially including holiday pay, sick pay and redundancy pay). This exposure was estimated at over £3 million per month, subject to a reduction for consents (sought by the administrators following their appointment).

The Scheme

No draft legislation or regulations have yet been published in respect of the Scheme. Online guidance for employers provides that "[i]f you cannot maintain your current workforce because your operations have been severely affected by coronavirus (COVID-19), you can furlough employees and apply for a grant that covers 80% of their usual monthly wage costs, up to £2,500 a month".

The Scheme is intended to be available to companies in administration — as confirmed in *Carluccio's* — as well as those who are not in an insolvency procedure. Guidance provides that "[w]here a company is being taken under the management of an administrator, the administrator will be able to access the [Scheme]. However, we would expect an administrator would only access the [S]cheme if there is a reasonable likelihood of rehiring the workers. For instance, this could be as a result of an administration and pursuit of a sale of the business."

Treatment of employment contracts in administration and administrators' authority to pay employees

The appointment of administrators does not terminate contracts of employment, which continue in effect unless and until notice to terminate is given or the contract is repudiated.

Liabilities for wages/salary (and certain other amounts, including holiday pay and sick pay) arising out of contracts of employment adopted by an administrator are payable as a super-priority expense.[6] They rank ahead of the administrator's own remuneration and expenses, which in turn have priority over the claims of floating charge creditors and unsecured creditors. Administrators have an initial "safe" period of 14 days following their appointment to decide on the actions, if any, to be taken. Any action taken within that period does not amount to adoption of a contract.

In contrast, employees whose employment contracts are not adopted do not gain the benefit of super-priority; their claims are instead merely unsecured provable debts.

For adoption to take place, "the mere continuation of the employment by the company does not lead inexorably to the conclusion that the contract has been adopted by the administrator"; what is required is "some conduct by the administrator … which amounts to an election to treat the continued contract of employment with the company as giving rise to a separate liability in the administration".[7]

The Court of Appeal held in *Debenhams* that this "is a question of law: is the conduct of the administrator such that he must be taken to have to accept that the relevant amounts falling due under the employment contract enjoy super-priority? It is a wholly objective question, focussed entirely on the conduct of the administrator. … the issue is whether the officeholder has "continued" the employment of the relevant employees". This election is to be judged objectively, and not by reference to the subjective intentions of the administrators.

Administrators retain a general discretion to make payments they think likely to assist achievement of the purpose of the administration.[8] This broad power permits administrators to make payments to unsecured creditors, including employees. The Court of Appeal in Debenhams considered this provision to be "perhaps the most obvious source of authority" for payment of wages/salary to employees (in contrast to the approach taken in *Carluccio's* case, where greater reliance was placed on the administration expenses regime[9]).

Kirkland advise the lead investors in Debenhams (now shareholders, following a debt-for-equity swap).

The Kirkland team includes Kon Asimacopoulos, Partha Kar, Sean Lacey, Elaine Nolan, Karim Kassam, Kai Zeng and Seamus Vaughan Lucey.

1. [2020] EWCA Civ 600 — upholding the first instance decision of Trower J, dated 17 April, [2020] EWHC 921 (Ch).↩

2. For the purposes of paragraph 99, Schedule B1, Insolvency Act 1986.↩

3. *Re Carluccio's Limited (in administration)* [2020] EWHC 886 (Ch).↩

4. The court directed that the administrators could proceed on the basis that — for employees who had expressly consented to the variation of their employment contracts — adoption would occur when the administrators paid them (under their varied contracts) or made an application in respect of them under the Scheme. In contrast, the contracts of employees who had objected or not responded to the administrators' variation letter would not be treated as adopted by the administrators. See our Alert for further information.↩

5. As encapsulated in the skeleton argument on behalf of the administrators, which Trower J at first instance held accurately reflected the intended effect of the Scheme.↩

6. Under paragraph 99, Schedule B1, Insolvency Act 1986.↩

7. *Powdrill v Watson & Anor (Paramount Airways Ltd)* [1995] 2 AC 394.↩

8. Under paragraph 66, Schedule B1, Insolvency Act 1986.↩

9. Under paragraph 99, Schedule B1, Insolvency Act 1986.↩

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