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# Administrators adopt furloughed employee contracts

**KEY POINTS**

- HMRC's guidance confirmed that the government's Coronavirus Job Retention Scheme could be accessed by companies in administration. This subsequently led to court applications being made by both the administrators of Carluccio's and Debenhams.
- The Court of Appeal has confirmed that a mere failure to terminate an employment contract within the first 14 days of the administration does not, of itself, amount to adoption for the purpose of para 99(5) of Sch B1 of the Insolvency Act 1986.
- Instead, there must be some other conduct carried out by the administrator that amounts to an election to treat those contracts as continuing in order for them to be 'adopted' and given super-priority. This key legal point is likely to retain significance post COVID-19 and the government's Coronavirus Job Retention Scheme.

The administrators of Carluccio's and Debenhams each made an application to court early in the lockdown period for directions on how to treat furloughed employees in administration. In particular, the issue was whether furloughed employees' contracts of employment were necessarily adopted for the purposes of para 99 of Sch B1 of the Insolvency Act 1986 (the 'Act'). Both High Court judges and the Court of Appeal unanimously agreed that operating the furlough scheme in respect of an employee amounts to adoption.

The judgments in *Carluccio's* [2020] EWHC 886 (Ch) and *Debenhams* [2020] EWHC 921 (Ch); [2020] EWCA Civ 600, arrived at during the early days of the Coronavirus lockdown and before seeing the detail of the legislation that brings the government's Coronavirus Job Retention Scheme (the 'Scheme') formally into effect, will have significance for every administrator intending to use the Scheme under which grants are available to fund payments to furloughed employees.

## ADOPTION OF EMPLOYEES IN ADMINISTRATION AND WHY IT MATTERS

Adoption of employment contracts in administration is key for both employees and administrators because employees whose contracts are adopted are entitled to super-priority payments of qualifying wages and salary as an administration expense rather than as an unsecured claim. Qualifying wages and salary for these purposes means wages and salary for services provided during the period of the administration (including holiday pay), but does not include contributions to an occupational pension scheme, redundancy or unfair dismissal payments (para 99(5) and (6) of Sch B1 of the Act). It is therefore crucial for administrators to only adopt those employment contracts that they can afford to pay.

The rules provide that nothing the administrators do in the first 14 days of the administration counts towards adoption of employment contracts. So in normal times, administrators have a 14 day grace period at the start of an administration to set their strategy and decide which employee contracts to adopt and which to terminate according to which employees are needed for the purpose of the administration.

In normal times, therefore, employees are either retained and continue to provide services while being paid their qualifying wages and salary as a super priority expense, or they are dismissed within the first 14 days.

In Coronavirus times, however, the picture has changed: the combined effect of trading restrictions and the Scheme is that rather than paying employees to provide services for the benefit of the administration, furloughed employees will instead be paid *not* to provide services.

## THE SCHEME AND ITS TERMS

Many businesses have closed for an indefinite period due to the Coronavirus pandemic measures and consequently, employees cannot continue to work. The government has introduced the Scheme to enable employers, including those in administration, to furlough employees whose services cannot be used. Furloughed employees are not permitted to work for their employer during the period of furlough. The employer can apply for a grant from the government to cover the cost of continuing to pay the employees 80% of their regular salary (up to a maximum of £2,500 per month) plus the associated employer National Insurance contributions and minimum automatic enrolment employer pension contributions on that wage.

Guidance was originally published on 26 March in relation to the Scheme, which is now expected to cover the period from 1 March 2020 until October 2020.

## CARLUCCIO'S ADMINISTRATION AND ITS EMPLOYEES

Before the Coronavirus pandemic hit the UK, Carluccio's operated a chain of Italian restaurants but it was forced to shut its doors in accordance with the government's lockdown measures and subsequently went into administration on Monday 30 March. The administrator's strategy was to mothball the business so far as possible and seek a buyer for some or all of the restaurants.

With that purpose in mind, the administrators wrote to almost 1800

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restaurant employees (the 'Variation Letter') offering to furlough them in accordance with the Scheme, provided they consented both to the furlough conditions (ie not turning up to work for at least three weeks) and to cap their pay during the furlough period to the maximum amount available to them under the Scheme. Further, the offer was limited to the extent that funds were received from the government under the Scheme to enable the company to pay the furlough payments to the employees. Employees were asked to email their consent by a certain date, and were informed that, if they did not consent to the terms, the administrators would need to consider whether to make them redundant. At the same time, the administrators applied to court for directions on the question of if, when, and on what terms the administrators would adopt these employees' contracts.

By the time of the hearing, the vast majority of these employees had consented to vary their contracts in accordance with the terms of the Variation Letter (the 'Consenting Employees'), a very small number had responded that they did not consent and would prefer to be made redundant (the 'Objecting Employees'), and 77 had not responded at all (the 'Non-Responding Employees').

It was this latter group for whom the directions application was the most significant. The lack of response from the Non-Responding Employees could have been for a number of practical reasons. Nevertheless, unless the administrators could be comfortable that they would not be adopting the contracts of the Non-Responding Employees if they allowed them to continue beyond 14 days from appointment, then the administrators would likely have to make these employees redundant within those 14 days.

## THE JUDGE'S DECISION IN CARLUCCIO'S

After an urgent hearing spanning four days, Mr Justice Snowden handed down a comprehensive judgment that provided the administrators with a means of reconciling the furlough scheme and the administration regime.

Snowden J's conclusions were as follows:

1. In relation to the Consenting Employees: their contracts had been varied in accordance with the Variation Letter and would be adopted on the earlier of the administrators making (i) payments to them under the Scheme; or (ii) an application in respect of them under the Scheme.
2. In relation to the Objecting Employees: their contracts had not been varied by the Variation Letter and their contracts had not been adopted by the administrators.
3. In relation to the Non-Responding Employees: their contracts had not been varied in accordance with the Variation Letter unless or until they subsequently accepted the offer prior to termination of their employment contract. Adoption of the contract of such a late-consenting employee would take place as in 1 above.
4. Objecting Employees' and Non-Responding Employees' claims referable to the period before termination of their contract would be unsecured claims in the administration.
5. The administrators were not under any duty to apply for a grant under the Scheme in respect of any Employee, other than a Consenting Employee, or a late-consenting Non-Responding Employee whose contract was varied as in 3 above.
6. Failure to terminate a contract, by itself, does not amount to adoption.

## VARIATION OF THE CONTRACTS OF EMPLOYMENT

First Snowden J addressed the question of whether for each category of employee, their employment contract had been varied by the Variation Letter or otherwise. Unsurprisingly, he decided that the contracts of the Consenting Employees had been varied in accordance with the terms of the Variation Letter when those employees signalled their consent accepting its terms. Also unsurprisingly the Objecting Employees' contracts had not been varied.

In respect of the Non-Responding Employees, the judge acknowledged that employee contracts can, in principle, be varied by implied consent. However, following the case of *Abrahall v Nottingham CC* [2018] ICR 1425, and taking into account Carluccio's particular circumstances where employees were not continuing to provide services, and so there were no sensible grounds on which to base any implied consent, there was no clear inference that the Non-Responding Employees had consented to the variation proposed.

## THE MEANING OF 'ADOPTION' AND POWDRILL V WATSON

The leading case on adoption is the House of Lords' decision of *Powdrill v Watson v Anor (Paramount Airways Ltd)* [1995] 2 AC 394. In normal times Lord Browne-Wilkinson's judgment in this case makes perfect sense, but in Coronavirus times it unfortunately gave rise to the uncertainty behind the directions application. Before Coronavirus, the case might have been described as establishing the principle that 'contracts of employment that are continued by an administrator for more than 14 days after appointment are adopted for the purposes of [what is now paragraphs 99(5) and (6) of Schedule B1 of the Insolvency Act 1986].'

However, applying this principle to the furloughed employees in the Carluccio's administration gave rise to some difficult issues.

## QUESTIONS FOR SNOWDEN J

The questions Snowden J had to answer in the particular circumstances were, for each category of employee, and in circumstances where those employees were not providing services in Carluccio's administration:

1. Whether the mere failure to terminate an employment contract meant that the administrators had adopted the employee's contract?
2. If mere failure to terminate did not amount to adoption, when (if at all) would any of the contracts be adopted? and
3. Where contracts were so adopted, on what terms would they be adopted: the terms of the Variation Letter or the original terms?

Put another way, could the administrators be sure that, to the extent they adopted any furloughed employee contracts, they only adopted the reduced furloughed terms, and therefore the amounts payable to furloughed

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employees would (save for certain accrued holiday pay) be funded by grants under the Scheme?

## POWDRILL V WATSON IN DETAIL

*Powdrill v Watson* contains three strands of reasoning, all of which point to adoption in the case of an employee who is continuing to provide services in a normal times administration, but which at first blush give rise to conflicting conclusions where employees are furloughed.

The first strand of reasoning is that the contract of an employee who, at the administrator's request, continues to provide services in an administration (and is paid for those services) is adopted. Applying this reasoning alone would lead to the conclusion that the contract of a furloughed employee would not be adopted because they are not providing services. This line of reasoning had been aired in the market in the period preceding the hearing but was rejected by Snowden J, who held that the concept of adoption was not synonymous with only the provision of services.

The second strand of reasoning in *Powdrill v Watson* concerns whether the employee's contract is continued. Lord Browne-Wilkinson in *Powdrill v Watson* states more than once in his judgment that continuation of the employment beyond 14 days from appointment meant adoption. And furthermore, an administrator cannot cherry pick different terms of the contract to adopt or reject. Continuation of the contract means adoption of the whole contract. If this reasoning alone were applied to furloughed employees in administration, then continuing the employment of the furloughed employees for more than 14 days (whether their contracts are varied or not) would point to adoption.

And finally, the third line of reasoning in *Powdrill v Watson* is based on whether the administrator elects to treat the continued contract of employment with the company as giving rise to a separate liability in the administration.

## SNOWDEN J'S INTERPRETATION OF POWDRILL V WATSON

After a thorough analysis of Lord Browne-Wilkinson's judgment in *Powdrill v Watson* Snowden J reconciled all three strands of reasoning and applied them to furloughed contracts.

First, he concluded that the concept of adoption should be interpreted so as to permit the Scheme to be given effect, and thus support the rescue culture and the government's efforts to deal with the economic consequences of the COVID-19 pandemic.

Next he relied upon another conclusion in *Powdrill v Watson* that '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' (see para 66 of the judgment). Instead, adoption rests on some conduct by the administrator that amounts to an election or decision that those liabilities arising under the continued contract will be a 'separate' (ie prior ranking) liability in the administration, rather than simply ranking as an unsecured claim. In a normal times administration, that conduct on the part of the administrator is likely to occur when the administrator communicates to the employee that the business remains open, and that the employee should attend for work in the usual way.

Then Snowden J interpreted the parts of Lord Browne-Wilkinson's judgment in *Powdrill v Watson* that refer to adoption of contracts continued beyond 14 days as confined to the context of whether an administrator could choose to adopt a contract in part rather than as a whole. Lord Browne-Wilkinson used the phrase 'continued for more than 14 days after appointment' as shorthand for the administrators' conduct amounting to an acceptance that he had to pay for services to be rendered under the contract, and hence an election to give super-priority to the claims for wages or salary (see paras 80-84 of the judgment). If interpreted in this way, this strand of reasoning is in fact shorthand, and not determinative on its own of the meaning of adoption.

Thus, Snowden J arrived at his conclusion, summarised above, that mere failure to terminate the furloughed employees' contracts does not, without more, amount to adoption. It follows that merely failing to terminate the employment contracts of the Non-Responding Employees would not amount to adoption. Adoption would occur if and when the administrators do something which amounts to an election or decision to pay furlough payments as a super-priority claim. Snowden J indicated that applying under the Scheme for a grant to pay such an employee, or alternatively paying the employees under their furloughed contracts (whichever happens earlier) would be such an election or decision and would therefore amount to adoption at that time.

## DEBENHAMS' APPEAL TO THE COURT OF APPEAL

A matter of days following the Carluccio's judgment, the administrators of Debenhams made a similar application before Mr Justice Trower in respect of approximately 13,000 employees who had been furloughed prior to the administrators' appointment (rather than post-appointment as had been the case in Carluccio's). In this application they sought a declaration that the employees' contracts would not be adopted by the administrators if the employees remained furloughed and the administrators took no further action except for (i) issuing communications confirming the terms of the employees' ongoing engagement, (ii) seeking any required consent in relation to such terms, and (iii) making payments to the furloughed employees of amounts that were to be reimbursed to Debenhams through its participation in the Scheme. Of particular concern to the Debenhams administrators was that, even if adoption could be limited to amounts recoverable under the Scheme, there was a risk of incurring additional liabilities to cover the cost of accrued holiday pay which was not covered by the Scheme, with the result that they might have to make a large number of employees redundant. Following the reasoning of Snowden J in Carluccio's, however, Trower J declined to make the declaration sought, finding that the administrators would have adopted the employees' contracts in these circumstances.

The administrators subsequently appealed to the Court of Appeal, arguing that the contracts were not adopted because they had not made any election to treat the liabilities of those contacts as having super-priority. The principal arguments advanced by Debenhams in support of this application were that the employees

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were not (and would not be) providing any services during the period in which they were furloughed, and that the payment of the employees' remuneration would be cost neutral to the company's estate because it would be paid either directly by Debenhams and subsequently reimbursed, or out of funds received from the government under the Scheme.

In a judgment given by Lord Justice David Richards, the Court of Appeal dismissed the appeal, finding that the furloughed employees' contracts would be adopted for much the same reasons as Trower J had given in his first instance judgment, in particular because:

1. The furloughed employees would remain bound by their employment contracts, including their duties of loyalty and requirements to remain available and provide services to Debenhams when it reopened.
2. The administrators continued to pay the wages or salaries of the furloughed employees pursuant to their contracts of employment, payment of which would be reflected in the tax position of both the employees and the company. The government could have devised a scheme which did not involve using the employer as the conduit for the remuneration, but it did not do so.
3. Prior to deciding whether to terminate the employment contracts at the end of the Scheme, the administrators will have taken steps to keep the contracts in existence, in the hope that the employees would be able to resume work either during the administration or on its conclusion.

## AUTHORITY FOR MAKING PAYMENTS UNDER THE SCHEME

In *Carluccio's*, Snowden J had held that para 99(5) and (6) of Sch B1 of the Act was the provision 'specifically designed to deal with the ability and obligation of administrators to pay wages or salaries to employees in an administration' and it was his working assumption that furlough payments would be paid to the furlough employees pursuant to these provisions (see para 56 of the judgment).

The Court of Appeal's conclusion on this point was that para 66 of Sch B1 of the Act (pursuant to which payments can be made by administrators where they are 'likely to assist achievement of the purpose of administration') was also an appropriate source of authority for making the payments and that the condition for making payments under para 66 was satisfied here. However, this was not found to undermine the conclusion that the administrators had adopted the employment contracts of the furloughed employees, and Richards LJ acknowledged that Snowden J's comments in this respect had not been an essential part of his decision on adoption in *Carluccio's*.

## COMMENT

The legal point of interest in the case, which will be of wider effect than just in relation to the furlough Scheme, is the confirmation at Court of Appeal level that mere failure to terminate an employment contract within the first 14 days of the administration does not, of itself, amount to adoption for the purposes of para 99(5) of Sch B1 of the Act 1986. Adoption requires some additional conduct on the part of the administrators that amounts to an election or decision that those liabilities arising under the continued contract will be a 'separate' (ie prior ranking) liability in the administration. Here such conduct would be applying for a furlough grant in respect of a particular employee under the Scheme, or paying them under their varied contract (whichever occurs first).

Crucially, the courts' collective conclusions mean that in most cases there will be no need to dismiss non-responding furloughed employees prematurely in a Coronavirus administration merely because of the risk of adoption.

However, both cases highlight some of the practical challenges that administrators face in furloughing employees when such furloughing will involve the adoption of their employment contracts. In particular, administrators are likely to face a very difficult decision when, despite multiple communication attempts, some of the employees do not respond with their consent to modify their employment contracts agreeing to only receive sums available under the Scheme, thereby limiting super-priority liabilities from the administrators' perspective (although in the case of both Carluccio's and Debenhams the administrators were ultimately successful in agreeing terms with the majority of the relevant employees). Indeed, the Court of Appeal was sympathetic to the challenges faced by the Debenhams administrators (particularly in relation to the issue of accrued holiday pay), even though their ultimate conclusion was that despite there being 'good reasons of policy for excluding action restricted to implementation of the Scheme from the scope of 'adoption' under paragraph 99… such exclusion cannot be accommodated under the law as it stands' (see para 71 of the judgment). ■

*Further reading*

- Practice Note: The 14-day rule and adoption of employment contracts in administration and administrative receivership – LexisPSL Restructuring and Insolvency; Employment and Insolvency; Employees
- Administrators of companies can furlough employees as an alternative to redundancy (*Re Carluccio's Ltd*) – LexisPSL Restructuring and Insolvency; Employment and Insolvency; Employees
- Employment contracts of employees furloughed prior to the commencement of administration are adopted by administrators if they keep the employees in the scheme (*Re Debenhams Retail Ltd*) – LexisPSL Restructuring and Insolvency; Employment and Insolvency; Employees
- Court of Appeal confirms that employment contracts of employees furloughed prior to the commencement of administration are adopted by administrators if they keep the employees furloughed (*Re Debenhams Retail Ltd*) – LexisPSL Restructuring and Insolvency; Employment and Insolvency; Employees