RE CARLUCCIO'S: A SERVING OF CLARITY FOR ADMINISTRATORS NAVIGATING THE ADOPTION OF EMPOYMENT CONTRACTS AND THE CORONAVIRUS JOB RETENTION SCHEME

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References to [ ] are to the relevant paragraph number of judgment reviewed below

Introduction

1. For creditors and company management alike in recent years, administration has become a popular substitute to winding up a company. In this challenging era created by the coronavirus pandemic, the number of administrations (including the recently conceived 'light touch administrations') may well increase in the forthcoming months.

2. Given the unprecedented situation arising from COVID-19, both insolvency and employment practitioners are likely to seek guidance from the courts to assist them in tackling a wide range of novel issues. *Re Carluccio's Limited* [2020] EWHC 886 (Ch) is an example of such a case in which Mr Justice Snowden provided useful guidance to joint administrators ("the Administrators") and considered the law on implied agreement in respect of proposed/purported contract variations in the context of the Government's Coronavirus Job Retention Scheme ("the Scheme").

What is Administration?

3. It goes beyond the scope of this case summary to detail all forms of administration for all bodies and their respective legislative origins. For example, there is a specific statutory regime applicable to building societies and some public-utility companies. In circumstances where administration is considered, tailored advice is necessary for each entity in question.

4. However, under Schedule B1 of the Insolvency Act 1986 ("the Act") a company is placed into 'administration' when a person is appointed under Schedule B1 to manage the Company's affairs, business and property (see Paragraph 1, Schedule B1 of the Act).

5. A person may be appointed in three potential ways under Schedule B1, either by way of court order or using the 'self-certifying' route:

Order of the court	See paragraph 10, Schedule B1 of the Act for further details
By the holder of a floating charge	See paragraph 14, Schedule B1 of the Act for further details
By the company or its directors	See paragraph 22, Schedule B1 of the Act for further details

6. When appointed, the administrators must act pursuant to the following aims:

    a. to rescue the company as a going concern; or

    b. to achieve a better result for the company's creditors than would have been achieved if the company was wound up (without first being in administration); or

    c. to realise property in order to make or distribute to one or more secured or preferential creditors (See Paragraph 3(1) of the Act).

7. In terms of making payments, the priority of asset distribution in insolvency law is too complex to be detailed herein. Nevertheless, for these purposes it is simply noted that administrators are able to make distributions to relevant creditors. Distribution in administration works in the same way as in a winding up scenario (see Paragraph 65, Schedule B1 of the Act). In brief, the administrator may make a payment to a creditor of a

company in the following order (if there are sufficient assets to make payment to all classes of debt in full):

a. Preferential debts should be paid in priority to all other debts. Preferential debts may include, for example, contributions to occupational pension schemes;
b. The expenses of the administration should be paid in full next;
c. Ordinary preferential debts should be paid next; and
d. Secondary preferential debts after that (See Section 175 of the Act for further details)

8. There are two relevant exceptions to the above:

a. Firstly, Paragraph 66, Schedule B1 of the Act provides that the administrator may make payment otherwise than in accordance with Paragraph 65 or Paragraph 13 of Schedule 1 of the Act, if he or she thinks it is likely to assist in the achievement of the purpose of administration.

b. Secondly, Paragraph 99, Schedule B1 of the Act provides when an administrator vacates office, if he or she has adopted any contracts of employment, such as wages or salary arising out of the employment contracts, these are payable out of assets held by the administrator in priority to the administrator's expenses. The administrator's expenses themselves have priority over claims of floating charge creditors and unsecured creditors [38 – 39]:

"(4)A sum payable in respect of a debt or liability arising out of a contract entered into by the former administrator or a predecessor before cessation shall be—

(a)charged on and payable out of property of which the former administrator had custody or control immediately before cessation, and

(b)payable in priority to any charge arising under sub-paragraph (3).

(5)Sub-paragraph (4) shall apply to a liability arising under a contract of employment which was adopted by the former administrator or a predecessor before cessation; and for that purpose—

(a)action taken within the period of 14 days after an administrator's appointment shall not be taken to amount or contribute to the adoption of a contract,

(b)no account shall be taken of a liability which arises, or in so far as it arises, by reference to anything which is done or which occurs before the adoption of the contract of employment, and
(c)no account shall be taken of a liability to make a payment other than wages or salary."

9. Employees whose contracts of employment are adopted by the administrators '*gain the benefit of super-priority'* under Paragraph 99(5) [41].

10. It is noted under Paragraph 99(5)(a) no action taken within the first 14 days of the administration can constitute or contribute to the administrators' '*adoption*' of the contract. The 14 day period is therefore known as the 'safe period'.

11. In respect of Paragraph 99(5)(c), liability for wages or salary includes holiday pay and contributions to an occupational pension scheme but does not extend to all liabilities under an employment contract. For example, it does not encompass redundancy payments; unfair dismissal payments; payments in lieu of notice or protective awards concerning employees whose employment has been terminated [38].

Brief summary of the facts in *Re Carluccio's Limited*

12. The Scheme was announced on 20th March 2020. Subsequently, written guidance was published which outlined who may be eligible under the scheme and the potential funds available to cover the wages of furloughed staff. In summary, the aim of the scheme was to enable employers:

"*including <u>those in administration</u>, to furlough employees whose services cannot be used in the current COVID-19 pandemic. Furloughed employees will not be permitted to work for their employer during the period of furlough, but the employer will be able to 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)"* [2] (underlining added for emphasis).

13. In this matter, the court made an administration order on 30th March 2020. The order was necessitated by the impact COVID-19 had on the company's ability to operate.

14. The Administrators planned to '*mothball*' the business in tandem with seeking to sell the same [13]. However, a significant challenge was presented by the lack of funds available to pay the continuing wages of the Company's staff. The Scheme presented a potential solution for the Company. There was a reasonable likelihood of the employees being 'rehired', that is to say, in the event of a sale of the business, the employees would transfer to the buyer and resume work after lockdown [22-23].

15. Following their appointment, the Administrators circulated letters to all employees ("the Variation Letter"), save for those who were assisting with the administration. The Variation Letter stated as follows [24]:

> *"our intention is that… you will be placed on 'Furlough Leave'. This means that your contract of employment continues, but you are not required to undertake any work…*
>
> *Under the Scheme, the Company understands that it will be provided with a grant equivalent to 80% of your regular wages… up to a maximum of £2,500 per month… [the 'grant']. It is our intention to claim for every eligible employee in full, however, I can confirm that the Company is unfortunately not in a position to meet the remaining portion of your regular wage given its financial position. By agreeing to go on Furlough Leave you also accept that your pay will be reduced for the period of Furlough Leave. Your varied contractual pay for this period will be the portion of your regular wages which the Grant will cover."*

16. The Variation Letter also made the point that the Company would only be able to pay employees if and when it received a grant from the Government [25].

17. It is important to note that the Variation Letter had been sent within the '*safe period*', during which time the actions of the Administrators shall not equate to the adoption of any employment contracts (see Paragraph 99, Schedule B1 of the Act and [5]). The 14 day safe period was to end on 13 April 2020 and so the Administrators sought urgent declarations before that date.

18. In broad terms, the Administrators wanted to retain the Company's employees and claim for them under the Scheme, rather than making them redundant. However, they were only willing to do so *'if and in so far as the costs of doing so can be met by the Government under the Scheme and they do not incur any greater liabilities for the*

insolvent company' [13]. Notably, as of 10am on 7 April 2020, 1,788 of the Company's employees had been sent the Variation Letter: 1,707 of them expressly accepted its terms (the 'Consenting Employees'), 4 rejected it (the 'Objecting Employees') and 77 had not responded (the 'Non-Responding Employees') [29].

19. In addition, the Administrators sought clarity in respect of whether (and if so under what mechanism), payments received by the Company under the Scheme could be paid to employees in priority to other claims against the Company [36]. Given that the Scheme guidance first published on 26th March 2020 [15, 20] suggested that the grant was to be accounted for as income, there was a concern that such payments would potentially be treated in the order of priorities set out in the Act (see Paragraph 65 of Schedule B1 of the Act and Section 175 of the Act, detailed above).

Issues

20. In light of the above, the Administrators sought determinations on a number of questions of law including:
    a. In respect of the Consenting Employees, had their contracts of employment been validly amended and, if so, what was the effect of the amendment?

    b. What was the position in respect of the Non-Responding Employees; was there implied agreement?

    c. How was the Scheme to work in the insolvency process: under what insolvency mechanism (if any) could payment received by the Company under the Scheme be paid to employees in priority to all other claims made against the Company by other creditors [69]?

    d. In respect of any employees who had not responded to the Variation Letter before the expiry of the 14 day safe period, were the Administrators able to avoid the adoption of their unvaried contracts, so that they were not forced to make all of those employees redundant [69]?

Employment law issues

The Consenting Employees

21. Snowden J held that the position in respect of the Consenting Employees was plain; the terms of their employment contracts had been varied [44-45]. It was equally clear that the contracts of the Objecting Employees had not been varied, such employees were to be made redundant.

22. In respect of the Consenting Employees, the effect of the variation is that the Company '*cannot be liable for wages or salary in any amount which exceeds the amount of the grant paid to the Company under the Scheme… and the Company is not obliged to pay the employee before receipt of the grant funds'* [45]?

The Non-Responding Employees

23. The position as regards the Non-Responding Employees was less clear. The Court considered the principles set out *Abrahall & others v Nottingham City Council* [2018] ICR 14 (CA), in paragraphs 85 to 89 and 107 to 110 (Underhill LJ and Sfir Patrick Elias). A very brief summary of which is as follows.

24. The parties to a contract of employment are in a complex relationship which requires the performance of mutual obligations on a continuous basis. In light of this and given that a contractual offer can be accepted by conduct, an employee's conduct of continuing to attend work is capable, in principle, of indicating acceptance of a contractual change proposed by the employer. However, while that may be true in some cases it will not always be so. What inferences can be drawn will depend on the particular circumstances of each case. The inference of acceptance must arise unequivocally. If the conduct of the employee in continuing to work is reasonably capable of a different explanation such conduct cannot constitute acceptance of new terms (see the 'only referable' test proposed by Elias J in *Selectron Scotland v Roper* [2004] IRLR 4). Employees must have the benefit of reasonable doubt. In addition, any protest or objection at the collective level may be sufficient to negative any inference of acceptance by an individual employee (*Rigby v Ferodo Ltd* [1988] ICR 29). It may be that acceptance of a proposed term can only be implied, from an employee continuing to work, after a period of time; for example, it may not be right to infer acceptance of a contractual pay cut from the day that it is first implemented.

25. Further, while agreement by conduct may often be readily inferred where the change is to the employee's benefit (e.g. in the case of a pay increase or promotion), there is a difficulty where the variation is to the employee's disadvantage. Such a difficulty may arise either where there is no compensating advantage or where it is being imposed to avoid a potentially worse disadvantage such as being made redundant. In the latter scenario, if the risk of redundancy can only be avoided by accepting new terms then, in appropriate circumstances, an employee might be taken to have accepted the new terms.

26. Having noted the principles summarised above, Snowden J recognised that the judgments in *Abrahall* were set in the *'normal background in which an employee continues to attend for work after a variation has been proposed'* [50]. That is to be contrasted with the facts of *Re Carluccio's* because the Company's employees were unable to attend work due to the Government's COVID-19 restrictions and, ultimately, Snowden J concluded that '*there is no other conduct on the part of the Non-Responding Employees from which I can infer consent'* [50].

27. Snowden J also observed that the Variation Letter expressly required employees to agree and indicated that redundancy might follow in the absence of agreement; the terms did not suggest that a failure to respond would be taken as consent to be furloughed but rather stated the opposite [51].

28. In addition, only a matter of days had elapsed since the Variation Letter had been sent [52]. As such, it was possible that not all of the Non-Responding Employees had received it let along considered it. Snowden J held that very strong evidence would be required to reach the conclusion that, without more, the absence of objection over such a short period could be equated to consent [52].

29. Finally, Snowden J noted that a few employees had rejected the terms proposed in the Variation Letter and there was no evidence before the court to explain why those employees had done so [53]. It was not possible to conclude that the considerations which weighed on the Objecting Employees would not apply to some of the Non-Responding Employees.

Insolvency law issues

The Scheme and the Insolvency Process

20. In summary whilst the court considered Paragraph 66, Schedule B1 of the Act was a useful tool for administrators in challenging times, Paragraph 99, Schedule B1 of the Act was identified as the provision 'specifically designed' to apply to administrators and their ability to pay wages or salaries to employees other than in accordance with the normal priorities during administration [55 – 56]. Therefore, in the court's view, Paragraph 99(5) in theory provided the relevant insolvency mechanism under which payments received by the Company could be paid to employees over other claims [91 – 93].

21. However, in practice in order to unlock the benefit of 'super-priority' for wages in this matter, the court would need to be satisfied that Paragraph 99(5) applied, in particular that the relevant contracts of employment had been adopted. Consequently, the court considered the meaning of 'adoption' with respect to Paragraph 99(5) and in particular the leading case of *Powdrill v Watson & Anor (Paramount Airways Ltd)* [1995] 2 A.C 394 ("Paramount").The learned judge highlighted from Lord Browne-Wilkinson's judgment that:

    a. "*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"* [66];

    b. Further "*adoption can only connote some conduct by the administrator… which amounts to an election to treat the continued contract of employment with the company as giving rise to separate liability in the administration"* [66]; and

    c. Adoption was an 'all or nothing' concept [67].

    d. The dicta at paragraph 67 which suggested that a contract was adopted if employment was continued for more than 14 days after the appointment, should not be taken out of its context. It did not mean that an employment contract would be adopted if an administrator failed to terminate it within 14 days. The reasons for this are dealt with at [81 – 84].

22. The court further reflected, as per *Re Antal International Ltd* [2003] 2 BCLC 406 ("Antal"), applying Lord Browne-Wilkinson's examination of the concept of adoption (see above), it was necessary on a case by case basis consider the facts and the conduct in question to ultimately decide whether an administrator had adopted a contract [87].

23. Prior to lockdown it was generally straightforward to identify the 'adoption' event. Ordinarily the administrator would indicate to the employee that the business was open and that the employee should attend for work [79]. Whereas the Administrators in this case could not simply invite the employees to attend work and in any event, needed guidance from the court to determine whether it was worthwhile adopting the contracts in question.

Consenting Employees

24. For the Consenting Employees, they were employed on the basis of a contract which was varied on the terms explored above within the 'safe period'. Nothing the Administrators had done amounted to the adoption of the varied contract yet [90].

25. However, Mr Justice Snowden opined that the following would amount to an adoption of the varied contract:

a. if the Administrators made an application under the Scheme in respect of Consenting Employees; or

b. if payment was made to the Consenting Employees under their varied contracts; or

c. if unanticipated funds were received and payments were made before the Company received funds under the Scheme [91].

26. The conduct identified in the aforementioned paragraph would amount to an adoption because the above are acts could only be explained on the basis that the Administrators "*were electing to treat the varied contract as giving rise to liabilities which qualify for super-priority"* [91]. Consequently, this would allow super-priority payments to be made to furloughed employees pursuant to Paragraph 99(5) of the Act, notwithstanding a mistake in the variation letter sought to disclaim any form of adoption [93 – 96].

Objecting Employees

27. Those contracts were terminated and the relevant Objecting Employees will be made redundant [97].

Non-Responding Employees

28. If the Non-Responding accepted the offer on the fifteenth day of administration or later, they would become Consenting Employees (see above for details) [98].

29. Nevertheless, there were three different scenarios which could otherwise arise in respect of the Non-Responding Employees [99 – 102]:

Non-acceptance within the first 14 days of administration	The Administrators would not adopt the unvaried contracts of employment. Further, even though the unvaried contacts still existed, the employees could not present themselves for work and therefore there does not appear to be any scope for the allegation that the Administrators elected to treat the unvaried contracts as giving rise to super-priority liabilities in the administration.
After 14 days in the administration if the Administrators have not withdrawn the Variation Letter or terminated the contract	If a Non-Responding Employee decided to accept the Variation Letter, this would not constitute an act of adoption, since it is not act an act of an Administrator. However, adoption would occur: a. when the administrator applies to vary the contract; or b. pays the relevant wages
Long-term Non-acceptance	Such Non-Responding Employees would remain employed by the Company on the terms of their unvaried contract until it is terminated.

30. On the whole, this was a good outcome for the Non-Responding Employees who faced potential redundancy before the end of the safe period when this matter came before the court for guidance.

31. The court also considered whether administrators were under a duty to apply under the Scheme [103 – 110]. Further in light of the spirit of the judgment determined above, the court rejected the argument that because furloughed staff were not providing a service, such a contract could not be adopted under Paragraph 99(5), Schedule B1 of the Act [70].

32. This decision has been applied in the recent decision of *Re Debenhams Retail Ltd (In Administration)* [2020] EWHC 921 (Ch) which concerned the proposed actions of administrators where the Company had furloughed employees prior to administration.

Comment

33. Overall, from an insolvency law perspective, this judgment provides useful points of clarification for administrators operating in unchartered territory who seek to take advantage of the Scheme and who may have been concerned about how to deal with employees of the company following the end of the safe period. Likewise, although Paragraph 66, Schedule B1 of the Act was not relevant to this decision, this judgment also serves as a reminder that this provision of the Act may assist administrators in dealing with the certain challenges that administrations present.

34. From an employment law perspective, while, in *Re Carluccio's*, the Court found that agreement to the proposed variation could not be implied in respect of the Non-Responding Employees, the door remains open to arguments that employees have impliedly agreed to contractual variations related to furlough. Future cases will of course turn on their own facts but Snowden J indicated that the following considerations will be relevant; '*I do not say that such an inference might not be capable of being drawn if the letter had been differently phrased, if it could be proven to have been received, if more time had elapsed, or if the particular circumstances of the Non-Responding Employees had been explained in more granular detail*'. Nevertheless, employers are likely to be in a safer position, as regards any breach of contract or unauthorised deduction from wages (Part II Employment Rights Act 1996) claim where they have evidence of express agreement to a proposed contractual variation; in the absence of specific advice, employers should not assume that the implied agreement principle will apply.

35. On a separate note, there remains some uncertainty as to whether an employer can make a valid claim under the Scheme in the absence of a written agreement from an employee to cease all work. This is a separate legal question from whether a contract of employment has been effectively varied to reduce an employee's entitlement to wages (which, as indicated above, does not necessarily require a written agreement). The Treasury's Direction dated 15 April 2020 suggests that such a written agreement is required (see paragraph 6.7). But HMRC Guidance (last updated on 20 April 2020) states as follows:

> *"To be eligible for the grant employers must confirm in writing to their employee confirming that they have been furloughed. If this is done in a way that is consistent with employment law, that consent is valid for the purposes of claiming the CJRS. There needs to be a written record, but the employee does not have to provide a written response. A record of this communication must be kept for five years*." [Emphasis added].

36. It is understood that today (23/4/2020), Jim Harra, HMRC Chief Executive and First Permanent Secretary, has stated in open correspondence (sent on his behalf) that:

> *the employer and the employee must reach an agreement and an auditable written record of this agreement must be retained. It does not necessarily follow that the employee will have provided written confirmation that such an agreement was reached in all cases.*

37. In light of the above, it seems unlikely that, in practice, HMRC will seek evidence of written agreement from an employee but the correct legal position has not yet been determined.

Whilst every effort has been taken to ensure the accuracy of the contents of this article, the position in relation to Covid-19 is rapidly changing. This document should not be used as a substitute for obtaining legal advice. To discuss this further with either of the authors or to instruct them for advice on this or any other matter, please contact their clerks Russell Porter (Email - russell.porter@3pb.co.uk) or David Fielder (Email - david.fielder@3pb.co.uk).

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