CASE REVIEW SECTION

The 'Rescue Culture' Survives as a Result of the Court of Appeal's Recent Ruling on Administration Expenses

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On 9 August 2005 the Court of Appeal overturned a landmark decision of the High Court which had called into question the priority of certain employment liabilities in administrations where the contracts of employment have been adopted by the administrator.[1]

The first instance decision

On 27 July 2005, the High Court ruled that where an administrator has adopted employees' contracts of employment, amounts due to employees in respect of protective awards and payments in lieu of notice (contractual or otherwise) take priority over the administrator's fees and the administration costs.[2]

Protective awards

The Employment Tribunals have the power to order an employer to pay an employee a protective award if it fails to consult with employee representatives of those employees who may be affected by proposed dismissals or by measures taken in connection with those dismissals, in a collective redundancy exercise.[3] In a collective redundancy situation, the consultation exercise must involve discussions with employee representatives about the ways in which the potential redundancies can be avoided, how the impact of a redundancy exercise can be minimized and the ways in which the consequences of the redundancies can be mitigated, before any dismissal can take effect. While this duty can be avoided where there are special circumstances which render such consultation 'not reasonably practicable', it has been held that insolvency, *per se*, does not amount to a special circumstance.

The obligation to collectively consult is triggered 'where an employer is proposing to dismiss as redundant twenty or more employees at one establishment within a period of ninety days or less'.[4] Consultation must begin in 'good time' and where one hundred or more redundancies are proposed at one establishment within a ninety-day period, at least ninety days before the first of the dismissals takes effect. Otherwise, consultation must begin at least thirty days before the first of the dismissals takes effect. Failure to comply with this obligation may result in the employer being required to pay employees remuneration from the date of the dismissal up to a maximum of ninety days. In administrations, it may not be in the best interests of the creditors for a period of collective consultation of up to ninety days to take place before the administrator makes the collective redundancies. As such employees who find themselves redundant after the administrator has adopted their contracts of employment and where the obligation to collectively consult has been triggered but not adhered to, will have a claim for a protective award of up to ninety days' pay each. In a large redundancy exercise conducted by an administrator after the employees' contracts of employment have been adopted and where commercial pressures are such that it is not possible to undertake collective consultation for the requisite period,

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1 *In the matter of Huddersfield Fine Worsteds Limited and in the matter of Globe Worsted Company Limited and in the matter of the Insolvency Act 1986 between Gerald Maurice Krasner (Administrator of the above named companies) v. Barry McMath (representing the employees of the above named companies) and In the matter of Ferrotech Limited and in the matter of the Insolvency Act 1986 between Adrian Tipper (representing the employees of the above named company) v. David Kenneth Duggins and Robert Hunter Kelly (Joint Administrators of the above named company) and In the matter of Granville Technology Limited and in the matter of the Insolvency Act 1986 between Richard Harris (representing the employees of the above named company) v. Martin Gilbert Ellis, Andrew Lawrence Hoskins and Leslie Ross (Joint Administrators of the above named company)* [2005] EWCA Civ 1072) ('*the Conjoined Appeal*').

2 *Krasner (Administrator of Globe Worsted Company Ltd & Huddersfield Fine Worsteds Ltd.) v McMath (Representing All Employees of the Companies)* [2005] EWHC 1682 (Ch) ('*Krasner*').

3 Section 189 of the Trade Union and Labour Relations (Consolidation) Act 1992.

4 Section 188 (1) of the Trade Union and Labour Relations (Consolidation) Act 1992.

this would have a significant impact on the success of an administration.

Payments in lieu of notice

The House of Lords' decision in *Delaney v. Staples*[5] correctly identifies four types of payment in lieu of notice:

(a) When an employer gives an employee full and proper notice but lawfully instructs the employee not to work during the notice period and instead gives the employee his wages attributable to that notice period as a lump sum. This is categorized as an advance payment of wages.

(b) Where the contract of employment expressly recognizes that the contract may be terminated by the employee working their full notice or by the employee receiving pay in lieu of notice upon summary dismissal. If exercised, this payment in lieu of notice would not be a payment of wages because it is not a payment for work done under the contract of employment.

(c) Where both parties agree that the employment is to come to an end forthwith on payment of a sum in lieu of notice. This would not amount to wages, as this is not remuneration for work done during the continuance of the employment.

(d) Where without the agreement of the employee, the employer summarily dismisses the employee and tenders payment in lieu of proper notice. Such a payment is not a payment of wages as it is not payment for work done under the contract of employment.

The High Court in *Krasner* decided that all of the four types of payment in lieu of notice identified above should be paid in priority to administrator's fees and administration costs. Such payments can be considerable where the redundancy exercise involves a large number of employees and/or the employees involved have lengthy notice periods and/or the employees have sizeable basic salaries.

The ruling in *Krasner*, therefore, had far-reaching implications for insolvency practitioners because it increased the types of liabilities payable as administration expenses and had a serious effect on an administrator's ability to save jobs and trade the company out of financial trouble. Administrations were introduced as a means of attempting to rescue potentially viable businesses and normally involve administrators continuing the business of the company concerned by retaining at least some of the employees. As such the rights of employees and the priority of the liabilities owed to employees by the company in administration is a hotly contested issue. Had *Krasner* remained good law it would have proved disadvantageous to future administrations and jeopardized the aims of the 'rescue culture' namely to achieve the best results for creditors of the company by rescuing companies and businesses. The administrator *Krasner*, unsurprisingly, appealed this decision to the Court of Appeal.

The Court of Appeal's decision

The Court of Appeal overturned the decision in *Krasner* during an expedited Court of Appeal hearing on 9 August 2005. This appeal was expedited on the application of the parties *In the Matter of Ferrotech Limited and in the Matter of Granville Technology Limited*,[6] who had obtained a finding from the High Court which refused to follow the decision in *Krasner*. The administrators in this case required urgent resolution of the conflicting decision in *Krasner* and *Ferrotech and Granville* by the appeal court because in relation to *Granville* the fourteen-day deadline for adoption of contracts of employment was due to expire on 10 August 2005 and in relation to *Ferrotech* if the matter was decided against the administrators, it would have sought to discharge the administration immediately and to put the company into liquidation. The Conjoined Appeal from *Krasner* and *Ferrotech and Granville* was accordingly heard together on 9 August 2005.

The Court of Appeal decided that liabilities for protective awards under s. 189 of the Trade Union and Labour Relations (Consolidation) Act 1992 and awards of pay in lieu of notice (except those that would otherwise be regarded as 'wages') are not payable in priority to any administrator's fees and the administration costs under Schedule B1 paragraph 99 of the Insolvency Act 1986 (as amended). Accordingly, a payment in lieu of notice will not be given 'super priority' unless it is regarded as 'wages' which broadly means unless it is a payment due when an employer has given proper notice but tells the employee not to work and gives the employee wages attributable to the notice period as a lump sum. An example of this would be where an employee is placed on garden leave. As a result, payments in lieu of notice on summary termination (contractual or otherwise) are not payable in priority to the administrator's fees and the administration costs.

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5 (1992) 1 All ER 944.

6 [2005] EWHC 1848 (Ch) ('*Ferrotech and Granville*').

Clarification of the Insolvency Act 1986 (as amended)

Schedule B1 paragraphs 99(4)–(6) of the Insolvency Act 1986 (as amended) provides that certain employment liabilities attract 'super priority' in the administration in that they rank ahead of other payments including not only the administrator's expenses but also the claims of preferential creditors, the amounts secured by a floating charge and the claims of unsecured creditors. These provisions were inserted by the Enterprise Act 2002. The drafting of these provisions is not entirely clear and it is of some relief that the Court of Appeal has resolved the ambiguity in Schedule B1 paragraphs 99(4)–(6).

(a) Paragraph 99(4) provides that 'a sum payable in respect of a debt or liability arising out of a contract entered into by the former administrator' will attract super priority.

(b) Paragraph 99(5) states that paragraph 99(4) applies in relation to 'a liability arising under a contract of employment which was adopted by the former administrator' provided that 'no account shall be taken of a liability to make a payment other than wages or salary'.

(c) Paragraph 99(6) provides a list of sums which are viewed as constituting 'wages or salary'. Paragraph 99(6)(d) expressly identifies the following type of payment: 'in respect of a period, a sum which would be treated as earnings for that period for the purposes of an enactment about social security'.

In *Krasner* the employees successfully argued that the effect of paragraph 99(6)(d) was that protective awards were to be treated as 'wages and salary' and once this was established for the purposes of paragraph 99(5) it followed that such a payment was treated by that paragraph as 'a liability arising under a contract of employment'. The Court of Appeal, however, held that a protective award did not fall within paragraph 99(6)(d) and even if it did this would still not bring such a payment within paragraph 99(5), namely a liability arising under a contract of employment.

The consequences of the Court of Appeal decision

Had the *Krasner* decision remained good law, the likelihood of administrators choosing not to adopt employees' employment contracts after the fourteen-day period would have increased resulting in unnecessary termination of employment contracts and corresponding damage to the underlying business and its future prospects. Administrators would have been forced to take this action to avoid becoming liable for sizeable protective awards and payments in lieu of notice, which under *Krasner* would have taken preference over preferential creditors. As a result the businesses would have closed down and attempts to sell the company as a going concern would have been thwarted. As the Court of Appeal correctly identified, this would have severely undermined the 'rescue culture' administrations are designed to promote.

The most poignant example of the negative effect *Krasner* would have had, had it been upheld by the Court of Appeal, is demonstrated by the response of the administrator acting for Granville Technology Limited to the decision in *Krasner*. At the end of July 2005, Granville Technology Limited appointed the administrator Grant Thornton. Grant Thornton immediately terminated the employment of the majority of Granville Technology Limited's employees (c. 1600 employees) prior to the expiry of the fourteen-day period for the adoption of employment contracts. It then made an urgent application for the review of the decision in *Krasner* before the expiry of the fourteen-day period for adoption of contracts. Had the *Krasner* decision stood, Grant Thornton would probably have made Granville Technology Limited's remaining 165 employees redundant immediately before the expiry of the fourteen-day period for adoption of their contracts. This decision would have been taken despite the fact that this would not have been in the best interests of the creditors or customers of Granville Technology Limited. However, it would doubtless have damaged the creditors significantly had, in accordance with *Krasner*, Grant Thornton made collective redundancies *post* adoption of the contracts of employment and had to pay out protective awards and payments in lieu of notice in priority to their own fees and the administration costs. Furthermore, the fees payable to Grant Thornton and their legal adviser's would potentially have been at risk and the willingness of insolvency practitioners to provide their professional services as administrators would have significantly diminished going forwards.

Those who support the commercial efficacy of the 'rescue culture' have, therefore, welcomed the Court of Appeal's decision. It is hoped that this decision has finally resolved the ambiguity in the drafting of Schedule B1 paragraphs 99(4)–(6) of the Insolvency Act 1986 (as amended) in much the same way as the decision in *Re Allders Department Stores Ltd*[7] has clarified that statutory redundancy payments and

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7 [2005] EWHC 172 (Ch).

statutory liabilities for unfair dismissal do not attract 'super priority' in an administration because they are not 'wages or salary' for the purposes of Schedule B1 paragraphs 99(4)–(6) and the statutory payments are not made under the contract of employment. It would appear that important steps have been taken towards fashioning the 'rescue culture' which was envisaged by the legislators in 2002.