



**BURTON
SWEET**

CORPORATE RECOVERY



BRIEFING NOTE

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DIRECTORS AS EMPLOYEES

When a business becomes insolvent, almost invariably employees not only lose their livelihoods, but are left out of pocket with wages, holiday pay and other entitlements unpaid.

Fortunately, under the provisions of the Employment Rights Act 1996 ("ERA"), subject to certain limits, employees are able to claim from the National Insurance Fund for:

- unpaid wages / salary;
- unpaid or accrued holiday pay;
- payment in lieu of notice;
- redundancy pay;
- basic award for compensation for unfair dismissal.

Unpaid pension scheme contributions may also be met from the Fund.

The issue which has caused difficulty in the past has been the position of directors of companies, particularly controlling directors. After all, the argument went, it is not possible to dismiss a controlling director who is, in effect, both employer and employee.

The matter has now been resolved in the case of Secretary of State for Business, Enterprise and Regulatory Reform v Richard Neufeld and Keith Howe, where the Court of Appeal has concluded that it is perfectly possible for a controlling director to be an employee and thus entitled to claim under the ERA. The issue is not one of the director's title; it is what he actually does in the business that matters. A director would need to demonstrate that he was more than a mere office-holder, and that he actually worked in the business.

The Court recognised that in many small companies, issues of directors' employment contracts are often dealt with very informally. In order to prove his status as an employee, ideally the director should have a written contract, or statement of terms, in place, even if not a formal service agreement. At the very least, it would be helpful for there to be a board minute or memorandum setting out the principal terms of the employment contract. Clearly the director will also need to have acted in accordance with those terms. The Court also warned against creating contracts simply for the purposes of securing a payment from the National Insurance Fund or for other ulterior purposes.

He should be able to show that PAYE and NI contributions have been deducted. It is important to note that the ERA provisions apply only in relation to salary, and not to remuneration drawn in some other way, such as directors' fees or dividends.

One of the arguments made by the Secretary of State in the case was that the directors had not taken their full holiday entitlements. No employee, it was argued, would be so foolish as to forego their maximum holidays. The Court rejected that argument, but did say that were a director to take more than their entitlement, that could militate against a finding that the director was an employee.

DIRECTORS AS EMPLOYEES

Of course, each case will turn on its own facts, but this case should give some comfort to directors who actively work in their companies that they should receive at least something back in the event of the failure of a company that they may have spent many years trying to build.

A note of caution, however, for buyers of insolvent businesses. If directors are found to be employees, then not only do they have entitlements under the ERA, they will also have other rights, notably under the Transfer of Undertakings (Protection of Employment) Regulations 2006 ("TUPE"). In those circumstances the purchaser will assume the company's employment obligations to its directors. As it is unlikely that an insolvency practitioner will give any form of warranty or indemnity, it would be wise for a buyer to enter compromise agreements with the directors before completing any purchase.

So the good news for directors may not be such good news for creditors. If claims from directors, some of which may be preferential claims payable in priority to ordinary creditors, are allowed then dividends will be diluted. Furthermore if purchasers need to negotiate side deals with directors, then the price obtained for the assets of the business may be less.

At Burton Sweet Corporate Recovery, we have vast experience in dealing with assignments involving insolvency and potential insolvency, be they large or small, straightforward or complex. Our objective is to give clear, professional advice when it is most needed.

IMPORTANT NOTE:

This briefing note is intended for general information only. It is not, and does not purport to be, a comprehensive statement of the law. It is not a substitute for specific advice which should be sought for specific cases. We cannot accept responsibility for any action (or decision not to take action) made in reliance on the content of this publication.

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