Something a bit Niffy -the ERA, the RPO and a failed CVA

The recent EAT decision in Secretary of State for Business, Innovation & Skills v McDonagh and others UKEAT/0287/12 and UKEAT/0312/12 (McDonagh) has highlighted a potentially unfair outcome for the employees of a company operating under a CVA that subsequently moves into administration or liquidation. If those employees are owed wages or accrued holiday pay at the time the Company moves into administration or liquidation, they will be unable to recover these sums from the Redundancy Payments Office (RPO) under the statutory scheme.

After languishing unloved in the backwaters of the Insolvency Act 1986 for many years, we have seen a recent resurgence in the use of CVAs, championed as a solution to the woes facing high street retailers that need to manage down their rent roll, without facing the ignominy and negative impact of a formal insolvency. "Good" CVAs that stand a reasonable prospect of success will usually involve a significant capital injection that enables a swift return to creditors, without impacting on day to day cash flow.

Unfortunately, not all CVAs are capable of being set up on this basis and rely instead on the Company making monthly contributions for a prolonged period, perhaps over 3–5 years. Inevitably, some of these will fail, perhaps because trading is not as strong as forecast, or suppliers withdraw support, or costs of production rise.

When a CVA fails, the supervisor is obliged to take steps to address that failure. Equally, the incumbent management need to take steps to meet their directors' duties to creditors. Often, this will mean the Company entering into administration or liquidation.

What is not always fully appreciated is the interaction between the CVA and the subsequent insolvency and the impact that this has on the employees of the Company. The terms of the CVA will vary from case to case but typically a CVA will provide that, in the event that the Company enters into, for example, administration, then this will be a default that will entitle the supervisor to terminate the CVA and distribute the remaining CVA assets to the CVA creditors. This process does not happen instantly and there is a transition period where the CVA continues to run, whilst the Company is now also subject to the administration.

For the employees of the business, it is likely that the Company moving into administration or liquidation will trigger a large number of dismissals. Under Part XII of the Employment Rights A ct 1996 (the ERA), those employees will expect to receive a minimum guaranteed level of compensation in connection with their dismissal. On dismissal, the employees are issued with an RP1 form, which they submit to the RPO. The RPO will then make payment out of the National Insurance Fund (NIF) for the guaranteed statutory amounts and the NIF then claims as a subrogated creditor in the insolvency for the amount paid, enjoying preferential status pursuant to Sch.6 of the Insolvency Ac t 1986.

Payments from the National Insurance Fund

Employees ought to receive the following from the NIF under the statutory scheme (calculated subject to the current cap on the maximum weekly wage of GBP 450):

- Arrears of wages, up to a maximum of GBP 800.00.
- Up to six weeks' accrued holiday pay (maximum of one year's entitlement—can't carry over)
- Pay in lieu of notice—statutory entitlement only
- Redundancy pay—statutory entitlement only (based on length of service and age group)
- Occupational pension scheme—lowest of 12 months' contributions or 10 percent of 12 months' pay, or amount certified as payable
- Protective award—classed as arrears of pay for purpose of limits

The difficulty here arises because under the ERA, the right to receive these statutory payments is triggered at different points. Section 182 of the ERA provides that:

"If, on an application made to him in writing by an employee, the Secretary of State is satisfied that—

"(a) the employee's employer has become insolvent,

(b) the employee's employment has been terminated, and

(c) *on the appropriate date* [emphasis added] the employee was entitled to be paid the whole or part of any debt to which this Part applies,"

the Secretary of State shall, subject to section 186, pay the employee out of the National Insurance Fund the amount to which, in the opinion of the Secretary of State, the employee is entitled in respect of the debt.

The "appropriate date" is defined in s.185 ERA as follows:

- "Arrears of pay and holiday pay—the date the employer becomes insolvent;
- Unfair dismissal and protective awards—the later date of dismissal, insolvency or the date the tribunal made the award;
- For any other claim—the later of insolvency or dismissal."

Section 183 of the ERA goes on to define "insolvency". Under s.183(3) of the ERA, a CVA is an event of insolvency that triggers the right to receive payment under s.182.

Section 182(c) above is problematic, in circumstances where the employer is moving from a failed CVA into administration or liquidation. It will often be the case that employees will have been retained as part of the CVA and will have been paid during the CVA. Often there will not be any arrears of pay accrued at the start of the CVA, as the employees will have been paid up to date as part of the Company's efforts to keep the Company trading. At the point that the CVA fails and the Company moves into administration or liquidation, however, it is perfectly possible that the employees will not have been paid up to date and there may be significant wage arrears accrued.

Section 387 (3A) IA 198 6 defines the "relevant date" for determining the existence and amount of a preferential debt within an administration where the company has not been in any other insolvency process as the date the Company entered into administration. If the Company goes into CVA first, s.387(2)(a) IA1986 defines the "relevant date" as the date on which the CVA takes effect.

So, what does all this mean for employees being made redundant when a CVA fails?

A supervisor of a CVA has no statutory oversight duties over the Company's trading whilst it is in CVA—a trading CVA is effectively a "debtor-in-possession" procedure. There is no expenses regime equivalent to that which operates in an administration that would protect the employees, by prescribing that the supervisor is deemed to have adopted their contracts of employment. At the point the CVA fails and the employees are dismissed, they will have to rely upon their statutory rights for any arrears of wages or holiday pay due to them.

For the purposes of calculating a claim under s.182 ERA for arrears of pay and holiday pay, the "appropriate date" is NOT the date that the employees are dismissed, following the Company entering into administration or liquidation. It is the date that the Company entered into the CVA. It may well be that, at the date the Company entered into CVA, they were owed no arrears.

If, for example, they have continued to work for the Company during the CVA, up to the point of it entering administration, and have not been paid for two months beforehand, if they are then made redundant by the Administrators, the "relevant date" for calculating their preferential claim under s.387(2)(a) IA198 6 will be the date that the CVA takes effect NOT the date the company subsequently enters into administration.

Are employees still preferential creditors?

In practice, this means that those employees will be assessed as having no preferential claim in the administration. They will be assessed as having a preferential claim within the CVA but the date for calculation of that claim will be the date that the CVA took effect, NOT the date they were dismissed. Assuming there were no arrears at that point, the net effect is that the affected employees receive no preferential payment for the accrued arrears and lose the protection of the statutory safety net that ought to ensure they are paid at least the statutory minimum in respect of those arrears.

This was the issue that came before the Employment Appeal tribunal in the *McDonagh* hearing.

H.H.J. Langstaff, sitting alone, heard two appeals from the Secretary of State on the point. In each case, the employer in question had been operating in a CVA and moved into liquidation. The claimant employees had been owed arrears of pay and unpaid holiday pay, which the RPO had initially refused to pay. The employees brought a claim in the employment tribunal to recover these sums and, at first instance, the employment tribunals agreed that these claims ought to be met from the NIF, although the tribunals applied different rationales to justify this in each case. In the first case, the tribunal determined that wording should be implied into the ERA, which would allow for multiple insolvency processes to provide multiple trigger dates. In the second case, the tribunal had sought to place a purposive interpretation on the meaning of EC Directive 2008/94, which is implemented in UK legislation by the ERA, with a view to giving effect to the intention of the legislation, rather than placing a strict interpretation on the wording, working on the basis that the legislation was not intended to apply to CVAs and further could not have been meant to produce a result that prejudiced the employees in this way.

H.H.J. Langstaff undertook a very detailed and thorough analysis of the legislation, including the overarching EC Directive. He concluded that:

- The UK legislation did not permit a concept of "serial insolvencies" for the purpose of calculating the relevant date—there was only a single event of insolvency and the fact that the company then moved into a further insolvency process did not trigger a second relevant date for the purposes of the ERA. As H.H.J. Langstaff said: "..it is incoherent to suggest that a company which is insolvent by statute becomes insolvent again or in addition or in any additional way when wound up. The underlying state of insolvency has not changed." [para.35]
  - The EC Directive was intended to apply to CVAs as it was to liquidations and administrations;
  - The EC Directive specifically envisaged and allowed for Member States to place limitations on the state guarantee provided to employees affected by the insolvency of their employers. Although H.H.J. Langstaff acknowledged that this may produce an unfair result for employees in this particular situation, the domestic legislation was entirely consistent with the wording and intention of the EC Directive

On this basis, H.H.J. Langstaff allowed both appeals and determined that the NIF was not liable to pay the arrears of wages or accrued holiday pay due to the affected employees.

The impact of this could be alleviated to some extent if the CVA terms provide that any employees made redundant during the course of the CVA will be allowed to claim as preferential creditors for any arrears accrued at the point of their dismissal. However, s.4(4) of the IA1986 requires that any CVA proposal must preserve the rights of preferential creditors to be paid ahead of any unsecured creditor, and this can only be varied with the consent of all the preferential creditors so such a term may be difficult to incorporate.

Such a term would only help, however, if sufficient assets remain within the CVA to cover these claims. If interim dividends have been paid prior to the dismissal, the employees would only have a preferential claim for a dividend from the remaining pot, not on the total funds collected during the life of the CVA.

Injustice

We have acted recently on a matter where this question was referred to the RPO for consideration. We pointed out the perceived injustice to the affected employees. The RPO took a strict line in interpreting the legislation and refused to meet the affected employees' preferential claims for wages arrears and unpaid holiday entitlement from the NIF. The net result is that the redundant employees will only receive a fraction of their statutory entitlement by way of a dividend in the administration. The CVA assets had been distributed to the CVA creditors, being those creditors in existence at the beginning of the CVA.

There is no simple solution to this conundrum: when putting together a CVA proposal, the nominee should give thought as to how such claims will be met from the available assets. It is a matter of commercial judgment whether it would be appropriate to incorporate a provision that a "reserve fund" be held back from dividends to meet the statutory exposure to employee claims, in case of failure. The sum retained could be significant and other creditors may query why such a large amount should be held to one side, rather than released to the CVA creditors by way of interim dividend. This would also raise questions over how to classify those employee creditor claims within the CVA—as contingent claims, we would expect that they would be valued at GBP 1.00 for voting and dividend purposes until such time as they actually crystallise and become known.

In one of the cases under appeal in McDonagh, the employee in question had started work with the employer after the approval of the CVA and in ignorance of its existence, yet was still caught by the above legislative trap, since the relevant trigger date for assessing her claim remained the date of approval of the CVA. It is not clear how her claim was treated in the CVA but presumably she would not even have been a contingent creditor at the time of approval and would have had no entitlement to vote on its terms.

An alternative solution may be to alter the employees' terms of engagement, so that they are paid weekly in arrears during the CVA, to minimise the possible impact on them if there is a failure. This would carry an increased administrative burden on the Company and might adversely impact upon cashflow, however.

Failing such piecemeal solutions, it will require legislation to alter the definition of the "appropriate date" for the purposes of s.182(c) ERA and address this unsatisfactory state of affairs. In the face of government cutbacks, however, it is difficult to see there being much political impetus to amend legislation in a way that will increase the burden on the public purse.

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