SOCIETY OF PRACTITIONERS OF INSOLVENCY

TECHNICAL RELEASE 6

Treatment of Directors' Claims as 'Employees' in Insolvencies

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Introduction

1. This Technical Release gives guidance to members on the approach to be adopted when dealing with the assessment of claims from directors as 'employees' of insolvent companies in a manner acceptable to the Redundancy Payments Service (RPS) of the Department of Trade and Industry. It has been approved in draft form by the RPS but no liability attaches to the RPS in respect of such approval nor is the RPS in any way bound by any statement contained in this Technical Release. Members are reminded that Technical Releases are for purposes of guidance only and may not be relied on as definitive statements. Members are also referred to the Technical Release entitled 'Non-Preferential Claims of Employees Dismissed Without Proper Notice by Insolvent Employers'.

What Constitutes an 'Employee'?

2. The Employment Rights Act 1996 (ERA) provides for payment from the National Insurance Fund of some arrears of wages, holiday pay, pay in lieu and redundancy pay owed to the employees of insolvent companies.

3. Section 230(1) of the ERA defines an 'employee' as 'an individual who has entered into or works under (or, where the employment has ceased, worked under) a contract of employment'.

4. Section 230(2) of the ERA defines 'contract of employment' as a 'contract of service or apprenticeship, whether express or implied, and (if it is express) whether oral or in writing'.

The Position of Directors

5. In law, a company director is an office-holder. However, a director can also be an employee and this matter has to be considered on the basis of the evidence concerning the director's relationship with the company. It is essentially a matter of fact in each individual case.

6. The Employment Appeal Tribunal (EAT) in the case of *Eaton v Robert Eaton Limited* [1988] IRLR 83, gave guidance on the factors to be considered as follows:

   (a) Did the director have a descriptive title (eg managing director or technical director)?

(b) Was there an express contract of employment? If not, was there a board minute or memorandum in writing constituting an agreement to employ the director as an employee as required by section 318 of the Companies Act 1985?

(c) Was remuneration paid by way of salary or director's fees?

(d) Was remuneration fixed in advance or paid on an 'ad hoc' basis?

(e) Was remuneration by way of entitlement or, in effect, gratuitous?

(f) Did the director merely act in a directorial capacity or was he/she under the control of the board of directors in respect of the management of his/her work?

7. Another factor to be considered is whether the director paid Schedule E (PAYE) Income Tax and Class 1 National Insurance Contributions (NIC). As the working conditions of office-holders are more related to those of 'employed earners' than those of 'self-employed earners', they are treated for NIC and Tax purposes as 'employed earners'. However, payment of Tax and NIC as an 'employed earner' does not of itself confer employee status for the purposes of employment legislation: see *Wilson v Trenton Service Station Limited* EAT/100/87 23 June 1987. Indeed, this factor was considered to be 'neutral' in *Fleming v Secretary of State for Trade and Industry (SSTI)* [1997] IRLR 682, though it was taken into account in *SSTI v Bottrill* (below). Equally, deductions at the 'self-employed' rate do not necessarily preclude entitlement under the redundancy and insolvency provisions.

8. Where a director has forgone or postponed payment of 'salary' for a period, that may be evidence that his relationship with the company is not one of employment, since it is normally a fundamental term of a contract of employment that, in return for services, an employee will receive remuneration. The fact that a director is an investor in the company, guaranteeing a loan to it will also point against his being an employee: see *McQuisten v Secretary of State for Employment (SSE)* EAT/1298/95 11 June 1996.

9. In *Buchan v SSE* and *Ivey v SSE* [1997] IRLR 80, the EAT suggested the following questions:

(a) Is the director under the control of another?

(b) Is the director an integral part of another's organisation?

(c) Is the director in effect in business on his own account?

(d) What is the economic reality of the relationship between the director and the

'employer'?

(e) Is there mutuality of obligation between them?

(f) What is their respective bargaining power?

The decision-making body has to consider the relevance of all the factors, decide what weight to give to each of them, evaluate them and balance one against the other in order to arrive at a conclusion.

Directors with Controlling Shareholdings

10. Particular difficulties may arise in relation to a director who holds 50% or more of the voting shares in a company. In *Buchan v SSE* above, the EAT went on to hold that:

> 'If the claimant is able, by reason of a beneficial interest in the shares of the company, to prevent his dismissal from his position in the company, he is outside the class of persons intended to be protected by the provisions of the [ERA] and is not an employee within the meaning of that Act.'

The EAT concluded in that case that a director owning 50% or more of the issued shares of the company could virtually never be its employee for the purposes of the ERA.

11. On the other hand, in *SSTI v Bottrill* [1998] IRLR 120, the EAT found that the reasoning behind the above rule laid down by *Buchan v SSE* was unsound. The position was rather that:

> 'The shareholding of a person in the company by which he alleges he was employed is a factor to be taken into account, because it might tend to establish either that the company was a mere simulacrum or that the contract under scrutiny was a sham.'

12. In the *Bottrill* case, a managing director who was also, temporarily, 100% shareholder was nevertheless held to be an employee on the facts as a whole. There was one other director and two other employees. The intention was that 80% of the shares should go

to the US supplier, which in any event had 'real control'. Facts indicating employment were:

(a) he paid tax and NIC on that basis;
(b) he had no other employment;
(c) his contract of employment was signed and dated and indicated that he was an employee;
(d) he was entitled to holidays and sick pay;
(e) he worked every day from 8.30 am to 5.30 pm;
(f) he was paid by salary and not director's fees.

Against that were:

(g) his theoretical control over the company;
(h) the fact that he has taken only 8 out of 16 days' holiday in the last year;
(i) he had not received pay for the last month (because the cheque book was not available).

13. The *Bottrill* case subsequently went to the Court of Appeal ([1999] IRLR 326). The Court of Appeal upheld the decision of the EAT and stated that:

> ' … whether or not an employer/employee relationship exists can only be decided by having regard to all the relevant facts. If an individual has a controlling shareholding that is certainly a fact which is likely to be significant in all situations and in some cases it may prove to be decisive. However, it is only one of the factors which are relevant and certainly it is not to be taken as determinative without considering all the relevant circumstances.'

14. Counsel for the SSTI requested further guidance on the subject generally and the Court of Appeal responded as follows:

> 'We are anxious not to lay down rigid guidelines for the factual

enquiry which the tribunal of fact must undertake in the particular circumstances of each case, but we hope that the following comments may be of assistance.

'The first question which the tribunal is likely to wish to consider is whether there is or has been a genuine contract between the company and the shareholder. In this context how and for what reasons the contract came into existence (for example, whether the contract was made at a time when insolvency loomed) and what each party actually did pursuant to the contract are likely to be r

'If the tribunal concludes that the contract is not a sham, it is likely to wish to consider next whether the contract, which may well have been labelled a co the various factors usually regarded as relevant (see, for example, Chitty on Contracts 27th ed. (1994) para. 37 - 008), the degree of control exercised by the company over the shareholder employee is always important. This is not the same question as that relating to w shareholder employee and whether the constitution of the company gives that shareholder rights such that he is in reality answerable only to himself and incapable of being dismissed. If he is a director, it may be rel able under the Articles of Association to vote on matters in which he is personally interested, such as the termination of his contract of employment. Again, the actual conduct of the parties pursuant to the terms of the contract is likely to be relevant. It is for the tribunal as an industrial jury to take all relevant factors into account in reaching its conclusion, giving such weight to them as it considers appropriate.'

15. Thus, no single factor is likely to be conclusive and the RPS looks at all the factors to establish whether the director was an employee for the purposes of the ERA, as will an Employment Tribunal if necessary, and as too must the insolvency practitioner. The ERA provides for a right to refer to an Employment Tribunal in the event of disagreement with a decision made by the RPS or the insolvency practitioner. It is very difficult to appeal successfully against a decision of an Employment Tribunal on

this question because appeals are permitted only on matters of law and the decision on this point is usually treated as one of fact.

Dividends

16. The principles are equally applicable to admitting a claim for dividend purposes. The effect of such claims, or the entitlement to claim, will affect not only the direct claim by the director, but also those by banks or other creditors making subrogated claims.

17. In marginal cases, IPs are requested to liaise and consult with the RPS as suggested in their booklet *Guidance for Employers' Representatives*.

18. The IP has no authority to accept or reject claims on behalf of the RPS; nor is the RPS's view in a particular case binding on the IP.

Issued August 1999