

INSOLVENCY BULLETIN

**Number Five
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To: *All Insolvency Permit Holders*

NON-PREFERENTIAL CLAIMS BY EMPLOYEES DISMISSED WITHOUT PROPER NOTICE BY INSOLVENT EMPLOYERS

Formerly Statement of Insolvency Practice 5 (Scotland)

Introduction

1. This Insolvency Bulletin has been prepared for the use of insolvency practitioners (IPs) in dealing with the treatment of employees' non-preferential claims in insolvencies in Scotland. The purpose of this Bulletin is to harmonise members' practice and try to ensure that it is acceptable to the Redundancy Payments Service (RPS) of the Department of Trade and Industry in processing claims under the Employment Rights Act 1996 (ERA). 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 Insolvency Bulletin.

Payment in Lieu of Notice - Basis of Calculation

2. Payments in lieu of notice are a liability of the employer and depend on the terms of the relevant contract of employment, subject to the minimum periods of notice laid down by s86 ERA. The amount of the claim, calculated as below, is payable by the RPS out of the National Insurance Fund in the case of an insolvent employer under s184(1)(b) ERA, only insofar as it relates to the minimum statutory period of notice (but not any additional contractual period) up to the current statutory weekly maximum and subject to the definition of 'a week's pay'. Payment by the RPS does not prejudice the right of an employee to seek recovery of any other debts, or debts in excess of the statutory limits, from the insolvent employer in the usual way. Nor does payment by the RPS imply that the IP is bound to admit a claim, whether by the employee or by the RPS in subrogation, which the IP does not agree is legally valid.
3. The basis on which the RPS' liability under s184(1)(b) ERA has been interpreted by the courts is that the amount payable should be computed on a similar basis to damages for wrongful dismissal at common law. The essential principle is that the employee's income

(as limited by the definition of a week's pay in s221 ERA (formerly Sch 14 Employment Protection (Consolidation) Act 1978 (EPCA)) should be restored during the notice period to that which would have been received if proper notice had been given, but that the employee should take reasonable steps to mitigate the damage suffered by the employer's failure to give proper notice.

4. The guidance below gives, in the light of existing case law, the approach approved by the RPS's and SPI's legal advisers. The case law is, however, not definitive in all respects and, if on particular points an IP proposes an alternative approach which does not conflict with established precedent, and provides a sensible and equitable assessment, it is likely to be accepted by the RPS.
5. The starting point for the calculation is a (gross) week's pay as defined in s221 ERA. The case of *Secretary of State v Haynes* [1980] ICR 371 is authority that only the loss of remuneration payable under ss86-91 and 220-9 ERA (formerly Sch 3 and 14 EPCA) is to be taken into account by the RPS in calculating the putative 'damages'. Thus fringe benefits, even where they are a contractual entitlement, are disregarded by the RPS except where, like luncheon vouchers, they are sufficiently close to pay to form part of a week's pay. Any benefit in kind (e.g. free accommodation) is also disregarded (*S & U Stores Limited v Wilkes* [1974] ITR 425). The Haynes case is also regarded by the RPS as authority for excluding payments such as holiday credits, and by analogy employers' pension contributions, which do not form part of the remuneration payable to the employee in respect of the week or weeks in question.
6. In effect, it was held by the Employment Appeal Tribunal (EAT) in the Haynes case that the RPS's liability under ERA s184(1)(b) is somewhat narrower than the employer's common law liability, in that the RPS is concerned only with 'remuneration'. Thus, in that case, the purchase of holiday stamps was not regarded as pay in respect of the week in which they would have been purchased, partly because the employee would have lost his rights entirely if he had not taken the holiday by a certain date. In the Wilkes case, it was held that an additional weekly sum of expenses which was a genuine pre-estimate of anticipated expenditure by the employee was not 'remuneration', although any profit element would have been. It is accepted that use of a company car could not be classified as 'remuneration', but it does not necessarily follow that the employer's pension contributions can similarly be excluded and it is submitted that the Haynes case is not authority for excluding them. Thus, there are certain items, such as the value of use of a company car, which the employee could possibly claim against the employer (non-preferential) but not against the RPS.

Irrelevant Factors

7. The following factors should be disregarded in assessing the employee's claim:
 - (a) Redundancy Pay

The decision in *Basnett v J & A Jackson Limited* [1976] ICR 63 provides that redundancy pay is not a mitigating factor in assessing the amount of a claim for damages or pay in lieu of notice, on the basis that the redundancy entitlements are not founded on or connected with a breach of contract. This view has been adopted by the RPS and is thought to be the correct approach despite an earlier contrary decision in *Stocks v Magna Merchants Limited* [1973] 2 All ER 329 and the acceptance of the decision in that case in *Aspden v Webbs Poultry and Meat Group (Holdings) Limited* [1996] IRLR 521. In *Wilson v National Coal Board*, New Law Journal 4/12/80 p1146, a personal injuries case, the House of Lords confirmed the general principle here expressed, although they decided in that particular case, on its special facts, that redundancy pay should be deducted. (Gross damages were assessed on the basis that the employee would have continued in employment for the rest of his working life but for the injury, so it would be unreasonable not to make the deduction in such a case).

(b) Discretionary Social Security Benefits

See para 11(c) below regarding non-discretionary benefits.

(c) National Insurance Contributions (NIC)

Despite the first instance decision in *Cooper v Firth Brown Limited* [1963] 2 All ER 31 (a personal injuries case), it is considered that NIC of the employee should not be deducted from any payment of salary in lieu of notice. There are two reasons for this. First, the individual may lose the benefits which he would otherwise have obtained from these NIC and would thus be penalised twice if he lost the amount of the NIC themselves as well as the benefits. Secondly, if the individual is employed for at least one day during the week of his notice period, his NIC for that week will have already been paid.

(d) Retirement Pension

It is clear from the Court of Appeal decision in *Hopkins v Norcross Plc* [1994] ICR 11 that a pension payable under an employer's scheme should be treated as purchased by the employee's past work and is not deductible. As regards state pensions, the Pensioners' Earnings Rule was abolished in the 1989 Finance Act. It is no longer appropriate to deduct retirement pension monies from payment in lieu of notice claims. However, see para [8\(b\)](#) below regarding possible additional claims for loss of pension benefit.

(e) Protective Awards (possibly)

Previous practice was to deduct from pay in lieu of notice the amount of any protective award insofar as it related to the same period. Indeed s190(3) Trade Union and Labour Relations (Consolidation) Act 1992 (TULCRA) specifically provided for mutual deduction between the two amounts and the practice was upheld by the Court of Appeal in *Potter v Secretary of State for Employment* [1997] IRLR 21 (subject to appeal to the House of Lords). However, it was held in *EC Commission v UK* [1994] IRLR 412 that this power of deduction was not compatible with EC law in that its effect was that UK law provided no sufficient deterrent to encourage employers to comply with the consultation requirements of s188 TULCRA and s190(3) was accordingly repealed as from 30 August 1993. Therefore, it is now the RPS's practice not to reduce pay in lieu of notice by reference to a protective award or vice versa, where the first dismissal covered by the award was after 28 November 1993.

The textbooks seem to have assumed that the right of deduction has been effectively removed but it is submitted that this is highly doubtful. A protective award is an award ordering the employer to pay 'remuneration' for the protected period, that is, a period commencing on the date when the first relevant dismissal takes effect (or of the award, if earlier). Pay in lieu of notice relates to remuneration over, in many cases, precisely the same period. The repeal, without more, of an express provision for mutual deduction does not take away a right of deduction which may well be implicit by reference to s190 as it now remains. There is also an argument that the rule against double proof would prevent an office holder from admitting proofs under both heads, though this is likely to apply only if, notwithstanding the view of the RPS, the employer itself remains entitled to apply the deduction.

In view of the risk of duplicated claims, IPs should be more inclined than in the past to defend protective award cases and may refer to the RPS in cases of doubt.

(f) Other Benefits

Any benefits payable to an employee which arise from a private contract, as opposed to the State scheme, should not be set off in mitigation. Examples of these might include, as well

as an occupational pension (see para 7(d) above), unemployment pay from a welfare scheme administered by a trade union.

Additional Claims

8. The following factors may be required to be taken into account so as, where appropriate, to increase a person's claim:

(a) Fringe Benefits

Fringe benefits, such as a company car and car fuel, medical insurance subscriptions or rent-free accommodation, are likely to give rise to an additional claim where these are a contractual entitlement. A claim from an employee may well arise even though the RPS cannot consider fringe benefits under the ERA.

The value of a company car was considered in *Shove v Downs Surgical Plc* [1984] ICR 532, where the loss of use of a 4,200 cc Daimler over two and a half years, including petrol for 5,000 miles pa private motoring, was assessed at £10,000. On the other hand, in *Clark v BET plc*, [1997] IRLR 348, Timothy Walker J assessed entitlement to a chauffeur-driven car for business and private use including all running expenses, which was in fact used privately only for visits to the opera, theatre and dinner, and in essence placed at nil for tax purposes, apart from travel to and from work, at £2,000 pa.

The Inland Revenue for the 1994/95 tax year revised the basis on which the taxable benefit of a car is taxed. These rules were introduced to reflect more accurately the true value of a company car and the taxable benefit charge also provides a useful indicator of the value of the benefit. The Automobile Association also produces annual tables giving up-to-date information on the costs of running cars of various sizes and these are a more accurate, if more favourable to the employee, method of assessing the value of a company car to an employee.

(b) Lost Pension Scheme Benefits

The employer's likely contributions to a pension scheme in respect of the employee and/or any additional benefits expected to accrue to the employee during the contractual period of notice are likely to be claimed. Of course, the contributions will not necessarily fairly reflect the benefit and in many cases an actuarial calculation will be required. It is normally only in cases of fixed-term contracts where the pension scheme is determinable within the contract period that pension entitlements may to some extent be excluded from the calculations: see *Beach v Reid Corrugated Cases Limited* [1956] 1 WLR 807.

Mitigation

9. The principle of mitigation applies to payments in lieu of notice since the claim of an employee dismissed with no, or short, notice is in essence one for damages for breach of contract and an insolvent employer must apply all possible reductions. Mitigation is particularly difficult to apply since it may be notional as well as actual (what would the employee have earned if he had made the effort to find a job?). To facilitate accurate calculation of mitigation, the amount of the payment cannot normally be calculated until after the notice period has expired.

10. Mitigation does not apply where the contract itself provides for pay in lieu as an alternative to notice since there is then no breach of contract and the pay in lieu is a contractual entitlement: see *Abrahams v Performing Rights Society* [1995] IRLR 486. This is most likely to arise in the contracts of senior executives.

11 The different elements that may come into the calculation of mitigation are discussed separately as follows:

(a) Remuneration

Any income earned or received by the employee during the notice period, which would not have been earned or received if the contract of employment had not been terminated, should be deducted from the payment in lieu of notice. The authority for this is *Secretary of State for Employment v Wilson* [1978] ICR 200.

(b) Notional Earnings

A deduction for notional earnings because of the employee's failure to mitigate his loss may be made in those relatively rare circumstances where the notice period is substantial and/or it is sufficiently clear that the employee had the opportunity to obtain other income in the notice period and unreasonably failed to take that opportunity. It is reasonable, where notice of less than, say, three months is involved, not to pursue the question of notional, as opposed to actual, mitigation in respect of alternative earnings very far. The objective must be to produce a figure which is not over-generous but which genuinely compensates the employee for his loss over the notice period and therefore should not lead to litigation. The EAT confirmed in the case of *Secretary of State v Jobling* [1980] ICR 380 that the duty to mitigate does not drive an employee to unreasonable lengths, even though in that particular case they did decide that deduction for notional earnings should be made, because Mr Jobling deliberately chose not to draw a salary that was readily available.

(c) Non-discretionary Benefits

Any social security benefits or allowances which are not discretionary received by the employee during the period of notice, such as sickness pay, invalidity pay and maternity allowance should be deducted. The House of Lords in the case of *Westwood v Secretary of State for Employment* [1985] ICR 209 held, following *Parsons v BNM Laboratories Limited* [1964] 1 QB 95, that unemployment benefit (now replaced by Jobseeker's Allowance (JSA)) should mitigate the claim. Further authority in support of this is *Lincoln v Hayman* [1982] 2 All ER 819, where the Court of Appeal held that supplementary benefit as well as unemployment benefit should be deducted from special damages in a personal injury case.

The question of mitigation of notional JSA in cases where the employee has failed to claim JSA does not arise (except in rare cases where it is income-based) because no JSA is paid where pay in lieu is due, whether or not it has been received, pursuant to The Jobseeker's Allowance Regulations 1996 (SI 1996 No 207) reg 105(6).

(d) Unfair Dismissal

Any compensation for unfair dismissal awarded by an industrial tribunal should be deducted only to the extent that it represents loss of earnings in the notice period. It was held in *Berry v Aynsley Trust Limited* [1976] BLT No. 394 New Law Journal 27/10/77 p1052 and more recently in *Aspden v Webbs Poultry & Meat Group (Holdings) Limited* [1996] IRLR 521 that a deduction should be made in respect of a tribunal award of compensation for unfair dismissal. However, it is submitted that the basic award should not be taken into account and any compensatory award should only be taken into account to the extent that it reflects loss of earnings in the notice period, if it can be apportioned in this way. The Court of Appeal held in *O'Laioire v Jackel International Limited (No 2)* [1991] ICR 718 that a Tribunal's maximum award (then £8,000) was not deductible because it could not be allocated specifically to the notice period so the employer could not establish double recovery for the same loss. It may be worth noting, however, that the basic

award should be taken into account in the rare case where it is payable on the particular dismissal but would not have been if full notice had been given at the time of the short notice, eg, if the employee would have reached 65 in the meantime: see *Shove v Downs Surgical Plc* (para 8(a) above).

(e) Protective Awards (possibly)

See para 7(e) above.

(f) Tax

- (i) Amounts below £30,000. The full amount of tax which would have been payable by the employee if the amount in question had been paid as salary may be deducted from the amount due by the company and retained by the employer. In certain cases, it may seem that the cost of calculating the deduction would not be justified in view of the small amount of assets available in the liquidation. However, the RPS insist on a basic rate notional deduction being made on the notice payment which they pay under the ERA.
- (ii) Amounts exceeding £30,000. The correct principle is, it is submitted, to start by estimating the net amount which would have been received by the employee after the deduction of tax from his gross income (i.e. his actual loss) and then to take into account his liability to tax on the damages, so that the net amount payable to him should, as far as possible, equal the net loss suffered.

The tax position is considered more fully in the Appendix.

APPENDIX

Tax on Pay in Lieu of Notice

1. The following paragraphs set out, at the time of issue, what is understood to be the tax position on payments in lieu of notice. IPs should note that this is an area where there has been considerable professional comment and discussion. They are therefore advised to obtain their own detailed guidance.
2. In *British Transport Commission v Gourley* [1956] AC 185, the House of Lords decided that damages awarded in a personal injuries action for loss of earnings should be reduced by such amount as the plaintiff would have paid in tax had he in fact received those damages in the form of taxable income. If this reduction were not made, then clearly the plaintiff would be over-compensated for his loss, to the extent that the damages themselves were not subject to tax. This principle has been extended to damages awarded for wrongful dismissal by the EAT case of *Secretary of State for Employment v Cooper and Vinning* [1987] ICR 766 and must, it is submitted, also apply to payments in lieu of notice as these are similarly compensatory in nature. However, it should be noted that pay in lieu of notice is itself taxable where the employer is entitled to make such a payment under the contract instead of giving the full period of notice (see para 11 above).
3. The Inland Revenue has recommended that notional tax be assessed at the basic rate rather than using the individual's last known code number, since most employees should recover the tax allowances lost during the notice period, either as a direct refund or in subsequent employment.
4. Sometimes an employee (usually one who has remained unemployed) feels that he has still, at the end of the tax year(s) to which his notice payment relates, had too much notional tax deducted, because he has not used up his personal allowance from his total taxable income for the whole tax year(s). In these circumstances an employee may apply for a refund direct to the RPS and should request form RP13.
5. Where a notice period includes the date of a change in Basic Rate Income Tax, the balance remaining after any mitigation should be divided by the number of days (including Saturdays, Sundays and/or any other day on which the employee did not normally work) and then multiplied by the number of days before and after the date of change to give two sums on which the appropriate percentages can be calculated. It is also acceptable for the two tax calculations to be rounded down to the nearest pound.
6. In the case of payments in lieu of notice, the position is complicated by the fact that payments will be taxable to the extent that they exceed £30,000 (unless they are wholly taxable because there is a contractual entitlement to make a cash payment in lieu of notice (see App para 2 above)). The Income and Corporation Taxes Act 1988 ss 148 and 188 provide that any payment made in consideration of, or in connection with, the termination of the holding of an office or employment is (except as provided in Section 188) taxable on such portion (if any) as exceeds £30,000. There have been a number of interpretations as to how the Gourley principle should be applied in the light of the predecessors of Sections 148 and 188 but the correct method of calculating damages exceeding £30,000 would appear to be that adopted in *Shove v Downs Surgical Plc* (see para 8(a) above). This approach involves taking into account the tax to be paid on the payment so that the net amount received by an employee reflects the actual (net) loss suffered by him.

For Example

Entitlement to one year's notice or damages in lieu. Annual Salary £60,000 plus benefits.
1999/2000 tax bands.

	£	£	£
Gross salary		60,000	60,000
Benefits in kind (life assurance, medical cover, car etc) (a) (say)		<u>10,000</u>	<u>10,000</u>
		70,000	70,000
Personal allowance	<u>4,335</u>	(4,335)	
Taxable amount		<u>65,665</u>	
	£	£	
10% on	1,500	150	
23% on	26,500	6,095	
40% on	<u>37,665</u>	<u>15,066</u>	
	<u>65,665</u>	<u>21,311</u>	(21,311)
Tax Relief for married couples - £1,970 @ 10% (allowance) (abolished 6/4/2000)		<u>(197)</u>	197
		<u>21,114</u>	<hr/>
Net loss - 12 months' salary after tax (£70,000 - £21,114)			48,886
Less net mitigation (b) say		(5,000)	<u>(5,000)</u>
Total net damages (c)			<u>43,886</u>
To receive a net receipt of £43,886:			
Total net damage	43,886		
Tax free slice	<u>(30,000)</u>		30,000
	<u>13,886</u>		
Gross up £13,886 x 100/77(d)			<u>18,034</u>
Amount to be awarded			<u>48,034</u>

Notes to example

- (a) The value of any benefits in kind provided (eg the provision of cars and health cover) will need to be ascertained. Strictly speaking the value of benefits in kind should be added to the gross salary to determine total remuneration.

- (b) It will be noted that mitigation has been taken into account after the tax calculation. This was the method adopted in the Shove case. The RPS take the view that notional tax should be assessed after mitigation in order to ensure that an individual does not suffer financial loss from the failure to be given notice, even though an assessment before mitigation might in particular cases give more precise results. However, it is submitted that the employee is not adversely affected provided that the mitigation figure is itself a net one. Nevertheless, when calculating an ERA s184(1)(b) payment, IPs need to understand the RPS's method of making a notional deduction for tax after all other mitigating items which have been dealt with gross. It remains the responsibility of the IP to agree such claims submitted by the RPS.
 - (c) No amount has been deducted from the net damages for accelerated receipt.
 - (d) In this particular example, grossing up is at the standard rate because the total income, which is subject to tax (being the excess over £30,000) is less than ($£28,000 + £4,335 = £32,335$). In any event the employer is not concerned with higher rate tax where a form P45 has already been issued.
7. The fact that the payment will not in any event be paid in full because the employer is insolvent, and thus that the tax payable on the full sum will be reduced or not payable at all, should not be used so as further to reduce the claim.
8. In arriving at the reduction to be made under the Gourley principle, the Courts would, when assessing a damages claim with the benefit of hindsight, work on the basis of the ex-employee's actual liability to Income Tax during the year in question. Any deductions made by the employer in respect of payments in lieu of notice must of necessity be based on an estimated Income Tax liability and the most obvious and practical solution is to base the deduction upon the basic rate as that will in most cases be the employee's marginal rate of tax and it is the marginal rate which is appropriate. It may well be that the employee can show just cause why the notional deduction should be reduced because of an actual or expected change in circumstances but the obligation must rest on him to do so.
9. Where amounts over £30,000 are paid and a form P45 has already been issued, basic rate Income Tax must be deducted by the employer in respect of the excess over £30,000 and paid over to the Revenue. If form P45 has not yet been issued, the PAYE code should be applied and tax charged using the appropriate tax table rates. The employee will receive a tax credit in respect of this deduction to set against his liability to Income Tax.