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Best of both worlds

16 December 2009

By **Bettina Bender**

New guidelines set by the courts will be helpful in establishing whether shareholders can also be employees for the purpose of entitlement to redundancy benefits; but the boundaries of the test are yet to be explored, says Bettina Bender

There has been a long line of cases on the question of whether a controlling shareholder could also qualify as an employee and accordingly enjoy the various benefits and protections that flow from being an employee.

At first glance, this question may appear relevant to only a small number of companies and individuals. However, the recent economic downturn and resulting reluctance by banks to lend money to businesses has resulted in a disproportionate number of insolvencies. Smaller owner-managed businesses have been particularly hard hit and large numbers have had to declare themselves insolvent. Some 12,000 claims to the National Insurance Fund were made by directors in 2008.

The basic test, much litigated, as to whether an individual is an employee can be summarised as an obligation on the company to provide work and a corresponding obligation on the individual to accept and perform this work.

Previously controlling shareholders tended not to qualify as employees and the argument went that they could not be said to be under the control of the company; although there was conflicting case law on the issue.

Under part XII of the Employment Rights Act 1996 employees of employers who become insolvent are entitled to receive payments in respect of notice pay, holiday pay and statutory redundancy payments out of the National Insurance Fund. Currently, the maximum statutory redundancy payment is £11,400.

It was in this context that the case of the *Secretary of State for Business, Enterprise and Regulatory Reform v Neufeld and Howe* [2009] EWCA Civ 280 came before the Court of Appeal this year. The two cases are summarised as follows:

In 1982, Mr Neufeld started working for Neufeld Press Limited as a salesman. In 1988, he became a director and shareholder. Neufeld Press was transferred to another company, A & N Communications in Print Limited, in 2001 and Mr Neufeld became managing director and held 90 per cent of the shares, while working as part of the sales team. There were two further directors who held five per cent of the shares respectively. Mr Neufeld worked approximately 60 hours a week on sales and management tasks, he did not take his full holiday entitlement for some of his time at the company and he made a personal loan to the company as well as providing personal guarantees. He was paid a weekly wage subject to PAYE and national insurance. A & N Communications became insolvent in October 2005. He sought to make a claim to the National Insurance Fund for holiday pay, notice pay and a statutory redundancy payment. In total, his claim was for about £10,000.

The then secretary of state for trade and industry did not consider that Mr Neufeld as controlling shareholder also qualified as an employee who should be compensated under the National Insurance Fund. Mr Neufeld brought a claim in the Employment Tribunal. The employment judge held that Mr Neufeld was not an employee. This was overturned by the Employment Appeal Tribunal and the secretary of state appealed.

Mr Howe started Track Records in 1979 and then transferred the assets to TRM in 2004 on incorporation. He held 100 per cent of the shares and was paid a salary with PAYE and national insurance deducted. He borrowed further monies to invest in the business and provided personal guarantees. He subsequently put the company into voluntary liquidation. The employment judge held Mr Howe was an employee and the Employment Appeal Tribunal dismissed the appeal by the secretary of state but also gave leave for appeal to the Court of Appeal.

The existence of an employment contract

The Court of Appeal took the opportunity of revisiting the long line of conflicting cases on the issue of whether controlling shareholders could qualify as employees. The court referred back to the most recent case on the issue of controlling shareholders: *Clark v Clark Construction Initiatives Ltd and Utility Consultancy Services Ltd* UKEAT/0225/07. Here, the EAT put forward two overriding principles to determine whether an employment contract existed, which were that the tribunal should take account of all the relevant information and that as the "industrial jury" the tribunal's decision should stand unless it was wrong in law or perverse.

There were three categories of cases in which the tribunal could decide not to give effect to a contract of employment and this included where the contract was a sham, where the contract had been entered into for an ulterior motive or where the parties did not behave in accordance with the contract.

The EAT put forward a further eight guideline factors relevant to a tribunal's consideration, including:

1. The burden of proof is on the party denying the existence of the employment contract.
2. The possession of the controlling shareholding and/or the exercise of real or sole control over the company's activities did not prevent an employment contract existing.
3. The fact that an individual was an entrepreneur, had built up a company or would profit from its success did not mean an employment contract could not be found to exist.
4. Conduct in accordance with the contract was a strong indication that it was valid and binding.
5. Conduct that was inconsistent with the contract was potentially a very important factor against finding that a shareholder was an employee.
6. Failing to put a contract in writing was powerful evidence that it was not intended to regulate the relationship.
7. Taking loans from a company or guaranteeing its debts may exceptionally be relevant but in most cases was unlikely to carry weight.
8. While the fact that they had a controlling shareholding might cast doubt on an individual also being an employee, that fact alone would not resolve the doubt one way or the other.

Further refinement

The Court of Appeal in *Neufeld* adopted the *Clark* guidelines and refined them further. In relation to the first factor, where the employment relationship is challenged, the court must first be satisfied that an employment contract exists. In relation to the sixth factor, the Court of Appeal suggested that the absence of a written contract should not justify rejecting a claim if the parties' conduct pointed towards conclusion of a contract. Regarding the seventh and eighth factors, the Court of Appeal suggested these would usually not be relevant, but that would not always be the case.

The Court of Appeal found in Mr Neufeld's case that the tribunal had been wrong to take into account irrelevant considerations such as his controlling shareholding and the fact that he had lent money to the company and provided personal guarantees. The Court of Appeal further held that the tribunal had been wrong to consider that a failure to take the full annual leave entitlement suggested someone was not an employee (but also said that this may be viewed differently if a shareholder took more than their annual holiday entitlement).

The Court of Appeal concluded that a controlling shareholding did not preclude an individual qualifying as an employee, and on the facts both Mr Neufeld and Mr Howe were indeed employees and could bring their respective claims to the National Insurance Fund.

The *Neufeld* case will not only be relevant in the context of whether small owner-held businesses who fail will qualify for redundancy payments under the state redundancy fund. It also raises the issue of what will happen to the controlling shareholder/ employee on any sale of the failing business or part of the business as a going concern.

New rights

The shareholder employee will now technically transfer across to the purchasing entity under the Transfer of Undertakings (Protection of Employees) Regulations 2006 with his continuity of service and employment protections intact. This may act as a disincentive to any buyer of the failing business and the company may be asked to terminate the employment of the shareholder employer and ask him to enter into a compromise agreement if the sale is to go ahead. The shareholder employee will require an incentive to enter into this compromise agreement which usually takes the form of a financial payment. Alternatively, the purchase may decide to employ the shareholder employee or to terminate the employment at some later date, but again there will be a cost to the business.

Following the *Neufeld* case, the controlling shareholder/employee may now also benefit from the usual employment rights against the company which will include the right not to be unfairly dismissed and the right not to be discriminated against.

Neufeld has given the entrepreneur a whole new raft of rights and further litigation in this area will no doubt follow to determine the limits and extent of these new rights.

Postscript:

Bettina Bender is a partner specialising in employment law at CM Murray LLP. She provides contentious and non-contentious employment law advice to international, European and English publicly listed and limited companies

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