

EMPLOYEE OR SHAREHOLDER OR BOTH?

In a recent case the Court of Appeal has held that there is no reason in principle why a director and controlling shareholder cannot also be an employee, even if he had total control of the company. Clare Waller, a Director at HRJ LAW LLP, discusses the implications.

It has been generally accepted that directors can also be employees of the companies which they direct. However, until recently there has been conflicting legal authority about whether or not a controlling shareholder could qualify also as an employee. It is a question which can be important if the company becomes insolvent. If the shareholder can establish that they are also an employee they may have the right to claim certain payments, such as a statutory redundancy payment or unpaid wages, from the National Insurance Fund if the company lacks the financial resources to make the payments itself. This issue has now been clarified by the Court of Appeal.

In *Secretary of State for Business, Enterprise and Regulatory Reform v Neufeld and another* the Court of Appeal held that two controlling shareholders were also employees. The issue is likely to be of increasing importance given the current number of business insolvencies and the consequential claims by directors for payment from the NIF - there were around 12,000 in 2008, and the figure is expected to increase for 2009.



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The Court of Appeal set out new guidance for tribunals to bear in mind in determining whether or not a shareholder is also an employee of the company. In doing so the Court expressly rejected the view which was taken in previous cases that an individual could not be an employee (and therefore eligible to make a claim on the National Insurance Fund) if they were the controlling shareholder of a company. It also held that, in the event of an insolvency, the question of employment status had to be determined at the date when the company became insolvent, rather than, for example, the date at which the shareholder became a shareholder or an employee. This is in recognition of the fact that a relationship can develop and change over time rather than being a static thing recorded only in writing.

Lord Justice Rimer, giving the judgment of the court, said the court had first to determine whether or not the putative contract was a genuine contract. This would involve looking at what the parties said their relationship would be in writing and then comparing that to the reality of the situation. This recognizes the situation where the parties may draft a document which sets out the relationship which they would like to have with each other, but in practice it operates very differently. The second issue was whether, assuming the contract was genuine, it amounted to a contract of employment rather than a contract for services.

The Court recognized that sham contracts would almost invariably be in writing. Therefore whilst it is clearly sensible for parties to have a written contract setting out their relationship with each other, it is important to ensure that this resembles how that relationship will actually work. There would need to be an investigation into the circumstances of the creation of the formal employment contract or board minute.

The court would also have to determine whether or not the parties had acted in accordance with the contract. The court would need to be convinced that the contract was in force and operating in the way envisaged at the time of the insolvency.

In light of the above case it is increasingly important to identify whether it could be argued that a true contract of employment between a company and its director(s) and/or shareholders(s) exists since this will effect the individual in question's entitlements, and the procedures that must be followed when carrying out processes such as redundancies, dismissals and transfers. The need for written documentation to be reflected in the reality of the parties conduct has been emphasized.

If however it can be shown that a majority shareholder is, on a normal analysis, an employee of the company in addition to any other roles which he may have as shareholder and/or director, then they may have claims for unpaid sums which can be made against the National Insurance Fund in the event of company insolvencies. Clearly every situation is going to be fact sensitive and advice should be sought both in terms of written documentation to be put in place at the outset of a relationship and, if the worst should happen, and the business becomes insolvent.