MACFARLANES

HOLIDAY PAY: THE SAGA CONTINUES…

EMPLOYMENT

THE PROBLEM: UK v EU

The courts, both at national and at European levels, have grappled over recent years with the problematic interaction between the rights to paid time off enshrined in the European Working Time Directive (WTD), the mechanism for calculating holiday pay in the UK's Working Time Regulations (WTR), and the calculation of "a week's pay" in the UK Employment Rights Act (ERA).

The European Court of Justice has held that "normal remuneration" must be paid during holiday, where "normal remuneration" is taken to include payment for work that is "intrinsically linked to the performance of tasks which [the employee] is required to carry out under his contract of employment". [1]

It is also important to keep in mind that UK workers are entitled to three different sorts of holiday:

- four weeks (or 20 days for a full-time worker) – this comes from the WTD;
- plus 1.6 weeks (or 8 days for a full-time worker) – this comes from the WTR and is not mandated by the WTD (and effectively gives credit to workers for the eight public holidays available in the UK); and
- plus any additional contractual holiday agreed in the contract of employment.

The ECJ case-law is hard to reconcile with the UK provisions for calculating holiday pay, as we shall explore in this note. Note that the ECJ cases only deal with holiday under the WTD, the first sort of holiday noted above.

The ECJ decisions affect both incentive schemes and overtime, but it is helpful to examine the two aspects of pay separately.

OVERTIME

The UK system

The UK system for calculating holiday pay is found in regulation 16 of the WTR and ss.221-223 and s.234 of the ERA. In essence, those provisions draw a distinction between:

- **Type 1**: Workers with "normal working hours", for whom a week's pay (the fundamental pay unit for holiday pay purposes) is calculated by reference to those fixed normal hours (and so would not normally include overtime).
- **Type 2**: Piece workers, for whom pay varies with the amount of work done.
- **Type 3**: Shift workers, for whom pay varies with the time at which they work.
- **Type 4**: Workers with no normal working hours.

Under English law, workers in Types 2-4 receive holiday pay based on a 12-week average of their pay, although the precise calculation varies for each category.

The problem with the UK system

The historic problem has been:

- Overtime is dealt with in s.234 of the ERA. It expressly disregards overtime for Type 1 workers. The Court of Appeal has previously held that disregard of overtime in the section should be applied unless the overtime is both *guaranteed and compulsory*.[2]
- This results in a lower week's pay calculation, and therefore lower holiday pay, for workers who:
  - work overtime as and when they want to (voluntary overtime); or
  - might be required to work overtime if their employer tells them to (non-guaranteed, compulsory overtime).

The discounting of overtime for those doing voluntary overtime or non-guaranteed, compulsory overtime does not sit easily with the ECJ's requirement that workers receive normal remuneration whilst on holiday. Surely, it can be said, that if an employee works an extra three hours every week, week in week out, that should form part of her normal remuneration whether or not her employer is obliged as a matter of contract to offer it to her?

LAST WEEK'S JUDGMENT

In three test cases that hit the headlines last week, the Employment Appeal Tribunal has attempted to deal with some of these issues.[3]

The cases concerned workers who worked non-guaranteed, compulsory overtime. Unsurprisingly, the EAT held that the UK system did not adequately deal with the ECJ's requirement for normal remuneration. The EAT concluded that the offending sections of the UK system could, however, be revised so as to achieve the right outcome, such that a further reference to the ECJ was unnecessary.

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[1] See, most recently, Williams v British Airways plc [2011] IRLR 948
[2] Bamsey v Albon Engineering & Manufacturing plc [2004] EWCA Civ 359
[3] Bear Scotland Ltd v Fulton, Hertel (UK) Ltd v Woods, Amec Group Ltd v Law UKEAT/0047/13

The revisions set out in the judgment effectively disapply s.234 of the ERA. This means that workers doing non-guaranteed, compulsory overtime are entitled to use a 12-week average to calculate their weekly pay.

A second element of the UK system was also disapplied. This is found in s.223(3) of ERA, under which enhanced hourly rates for overtime are ignored for calculation purposes. This means that the 12-week average should now take full account of the overtime actually worked and the hourly rates actually received in respect of that overtime.

There are some other points worth noting from the judgment:

- Although the judgment is explicitly concerned only with non-guaranteed, compulsory overtime, the disapplication of the offending parts of the UK system may also result in those working voluntary overtime having their holiday pay increased too. The judgment does not deal expressly with voluntary overtime. Until the point is tested in the courts, employers have a choice to make. They may either assume the direction of travel is so clear that it is likely voluntary overtime will be included in calculations as soon as the courts examine the point, or they may choose to wait and see, hoping that the limit on historic liability will be upheld if the case is appealed, so limiting their exposure even if voluntary overtime is to be counted going forwards.

- The decision deals only with the European entitlement to holiday (i.e. the 20 days' leave mandated by the European WTD). The full UK system, with its disapplication of some forms of overtime, continues to apply for the additional eight days' leave set out in the WTR, and any contractual holiday on top of that is subject to whatever calculation mechanisms have been agreed by the employer and employee.

- The judgment has important things to say about historic liability, which we discuss in more detail below.

INCENTIVE SCHEMES

So what of an employee who receives a basic salary and some form of performance-based incentive? How is holiday pay calculated in that case? Is it basic salary only? Or should the incentive be taken into account too? If so, what sorts of incentive scheme are affected?

The starting point under the UK system is a Court of Appeal decision which determined that employees who receive commission on sales were Type 1 workers not Type 2 workers, on the somewhat flimsy basis that remuneration for this type varied with the result of work, rather than the amount of work done.[4]

Two key ECJ decisions have, however, clearly established the principle with which we began this note, that the entitlement to normal remuneration includes payment for all those tasks that are intrinsic to the employee's contractual duties.[5] The most recent, from May 2014, involved a salesman, for whom commission on sales achieved made up around 60 per cent total remuneration. As there was a time lag between closing the sale and receiving commission, and as he could not earn commission while he was on holiday, his pay packet in the months after holiday was lighter than it would have been had he not taken that leave and used the time to close deals instead.

The ECJ was heavily influenced by the health and safety policy background to the WTD, noting that a failure to include commission in holiday pay calculations effectively operated as a deterrent to the taking of holiday. For that reason, commission must be included in holiday pay calculations.

But how precisely that calculation operates is far from clear. The Advocate-General (who gives non-binding opinions on ECJ cases before they go to the full Court) suggested a longer reference period than the 12-week average found in the UK system, perhaps to dampen the effect of seasonal variation in sales. This is expected to be addressed by the Employment Tribunal in 2015, so remains a point for debate. Our best guess is that the reference period in each case will need to be set so that it achieves a fair result. So for an annual incentive scheme, a 12-month reference period would seem sensible.

The ECJ case involved a sales commission scheme. Employers operate a huge variety of performance-based incentive schemes, taking account of a wide range of indicators. We consider that a purely discretionary annual bonus scheme is readily distinguishable from a monthly-paid formulaic commission scheme. Most schemes will fall between those extremes, mixing some measurable elements with more subjective assessments of performance. The position for those types of scheme remains unclear. One solution is to make clear that any form of target is designed to be achievable by an employee taking their full annual holiday entitlement, so that it cannot be said that the scheme deters people from taking leave.

[4] Evans v Malley Organisation Ltd [2002] EWCA Civ 1834
[5] See footnote 1, and Lock v British Gas Trading Ltd [2014] EUECJ C-539/12 (22 May 2014)

HISTORIC LIABILITY

Under the ERA, a worker is entitled to take action if he is underpaid for an "unauthorised deduction from wages", in the jargon of the Act. The time limit for bringing a claim is three months from the underpayment or, significantly, from the last underpayment in a series. If, for example, I pay Shazia £7 per hour each week for the whole of 2014, instead of the £7.50 I am contractually obliged to pay her, she has until the end of March 2015 to submit a claim for the total shortfall.

In the holiday pay context, this rule might be thought to allow very substantial historic claims: Lee has worked overtime since the late 90s, but his holiday pay was always based on his basic salary only without overtime. He discovers from last week's judgment that his employer was wrong all along. Is it right that he can now make a claim on the basis that all the underpayments of holiday pay were part of a series, for which he can now seek compensation?

The EAT's answer last week was no. Since the aim of the ERA is to remedy underpayments quickly, any gap of more than three months means older payments are no longer actionable. This is welcome news for business, as it curtails the scope for historic claims. However, because this decision deprives the union-funded claimants in the case from the bulk of the value of their claim, an appeal seems inevitable.

FINAL THOUGHTS

We have tried to be as clear as possible in this note, but holiday pay remains one of the most complex areas of employment law. Given the likelihood of further appeals, and the Government's announcement this week of a taskforce to review the effects of the EAT's judgment, we will keep you updated on further developments as they arise.

If you have particular practical issues you would like to discuss, please do not hesitate to contact us. Similarly, if you would find it helpful for us to run through the issues in this note with you or your team in person, please do get in touch.

CONTACT DETAILS

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