Holiday Pay – Summer Update UPDATED

27 July 2022

It's that time of year when many will be taking a break, jetting off to sunny climes or enjoying the sunshine at home. So fasten your seatbelts as we take stock of developments in the world of holiday pay and how these could impact your holiday pay bill and calculations.

Historical liability: the "three-month rule" revisited

Since 2015, the so-called "three-month rule", first approved by the EAT in the case of *Bear Scotland Ltd v Fulton*, has been a useful means for employers to limit their exposure to holiday back-pay claims presented as a "series of deductions" under the Employment Rights Act 1996 (**ERA**). The rule provides that a gap of more than three months between deductions (ie between holiday underpayments) breaks the series, so that any such claims are out of time. Together with the statutory backstop that limits successful back pay claims to two years' worth of underpayments, this has helped employers to mitigate their risk of historical liability to a large extent.

The future of the three-month rule is, however, uncertain after several courts including, most recently, the UK Court of Appeal, have cast doubt on its validity, although with no binding consequences for other courts or tribunals. Now the Supreme Court will have the final, and binding, say on this issue when it determines an appeal against the Northern Ireland Court of Appeal's ruling in *Chief Constable of Northern Ireland v Agnew* (2019), due to be heard on 14 and 15 December 2022.

Pending the Supreme Court's judgment (which may not be forthcoming for another year), the three-month rule should be used with caution. While it remains legally valid, it is highly likely to be challenged in future litigation. The safest approach is to avoid the need to rely on the rule by ensuring that your calculation approaches are compliant, particularly in relation to variable pay elements such as overtime and commission, and, indeed, many employers have reached this position.

Reviewing holiday pay calculations for "part-year workers"

Employers using so-called "part-year workers" face a higher holiday pay bill and a risk of back-pay claims following the Supreme Court's judgment in *Harpur Trust* v *Brazel* (given on 20 July 2022). "Part-year workers" are those employed or engaged all year round but who work only some weeks of the year. According to the Supreme Court, this group are entitled to the full 5.6 weeks' paid holiday each year, calculated at the rate of a "week's pay" under the ERA (as required by the Working Time Regulations 1998 (**WTR**)), not just to a pro-rated amount reflecting their actual hours worked. As a result, many part-year workers could get more holiday pay and, in some cases, proportionately more than their colleagues working a full year.

The case concerned a music teacher who was employed on a permanent, zero-hours, contract, and worked irregular weekly hours during term times. She was entitled to 5.6 weeks' paid annual holiday which she took during school holidays. However, relying on Acas guidance at that time (which has now been rewritten), the school calculated the hours that she had worked each term, took 12.07% of that figure (5.6 weeks equating to 12.07% of a standard year with 46.4 working weeks) and paid her hourly rate for that number of hours as holiday pay. This meant that she received less than she would have done had the WTR approach been used (12.07% of her working pay as compared with 17.5% using the WTR approach in one year). She brought a claim for unlawful deductions from wages for the shortfall and, while she lost at first instance, the EAT, the Court of Appeal, and now the Supreme Court, have found in her favour.

In the Supreme Court's view, the WTR (which implemented EU law and remain "retained EU law" post-Brexit) require the relevant ERA "week's pay" calculation formula to be used for all workers. For a part-year worker with no normal working hours, this means averaging their pay over the previous 52 weeks (12 weeks at the time this claim was brought) and disregarding weeks in which no remuneration was payable (save that, if there are disregarded weeks, earlier weeks make up the 52-week period, going back no earlier than 104 weeks prior to the calculation date). The Supreme Court found the 12.07% pro-rata approach, and other calculation methods that the school had proposed, to be in breach of the WTR. It accepted that there could be anomalies in exceptional cases, whereby some part-year workers get proportionately more holiday pay than full-time or part-time colleagues with regular hours, but concluded that the WTR must still be applied in this way.

Impact and managing risk

The Supreme Court's judgment has a cost impact not just with regard to teachers, but also any casual, zero hours or other part-time staff on permanent contracts working on an ad hoc or infrequent basis throughout the year, whose holiday pay has been calculated on the 12.07% basis. This group can expect more holiday pay going forward, based on the more generous WTR approach; those working only a small part of the year, in particular, will benefit as they accrue WTR holiday despite not working for long periods. They may also potentially litigate to recover past underpayments (alleging a series of unlawful deductions), although past liability can be mitigated to some extent (see below).

If you have been using the 12.07% calculation approach, key steps and risk management considerations are:

- Conduct an audit to identify workers (or former workers) employed or engaged on a permanent contract but for only part of the year and quantify your underpayments and historical liability in light of this judgment. Given the two-year backstop, you should look back at least two years, but potentially for a longer period for workers who may have been misclassified as self-employed and denied paid holiday (see **Managing contingent worker risks** below). Note that this judgment impacts only on part-year workers and not part-time workers who work every week (but for only part of a week).
- Discontinue using the 12.07% calculation approach for these workers and use the WTR approach to regularise the position going forward. This will not extinguish any past liability. As mentioned (see **Historical liability: the "three-month rule" revisited**), the three-month rule remains one line of defence in terms of mitigating past liability, but is unreliable, and the two-year backstop will limit your liability to two years of

underpayments in most cases. Review and, if necessary, amend contracts and policies to make them compliant with the WTR approach.

- A more wholesale restructuring of arrangements could be considered, whereby part-year workers are put on short-term or temporary arrangements to reduce your holiday pay liability. Any variation of existing contracts should be carefully implemented, having regard to contractual provisions, duties to inform and consult, duties of good faith and reputational considerations.
- Consider your strategy, particularly if large numbers of claims could materialise, and whether your preference would be to resolve these through negotiation to avoid lengthy and costly litigation. Trade unions will be alive to this issue (UNISON was an intervener in the proceedings even though it was not a party) and are likely to fuel worker claims.
- If you are a purchaser in an M&A transaction, consider measures that may be necessary, in terms of due diligence, warranties and indemnities, to protect yourself against additional holiday pay liability.

Managing contingent worker risks

Contingent worker disputes are another risk area for employers, as worker status litigation can bring holiday pay claims from those who are successful. In February 2022, the Court of Appeal ruled (in *Pimlico Plumbers Limited and another* v *Smith*) that a misclassified worker who took unpaid annual holiday could carry over his right to four weeks' paid holiday (the EU law-derived portion) without limitation from year to year and claim compensation in lieu on the termination of his engagement. This ruling and the 2018 ECJ ruling (*King* v *Sash Window Workshop*) leaves employers with contingent workers, in the gig economy or otherwise, who have been denied paid holiday or who have taken holiday on an unpaid basis, at increased risk of holiday back-pay claims and significant termination pay liability. The three-month rule will not assist to mitigate such liability as the worker's claim is for a single sum due on termination, rather than a series of deductions.

This underpins the need to identify your "workers" correctly, having regard to the working relationship in practice rather than just the documentation, and keep this under review. For those most at risk of being "workers", an option would be to provide them with paid holiday now, with a view to averting litigation and minimising future termination liability (even if this won't extinguish past liability). Please click **here** to see our blog on the key takeaways from this litigation and suggestions to help mitigate your risk exposure.

Brexit: business as usual

Lastly, the landscape has changed post-Brexit, but there has been no short-term impact in terms of changes to EU-law derived holiday pay rules. The UK courts and tribunals must continue to apply pre-2021 ECJ rulings when deciding cases relating to EU-law derived holiday pay (subject to an ability for the higher appellate courts to depart from those rulings in certain circumstances). Moreover, the Government has pledged to safeguard workers' rights, both as a matter of policy and, indirectly, as a term of the Trade and Co-Operation Agreement with the EU.

However, holiday pay rules are considered by employers to be one of the most burdensome pieces of EU legislation. In the longer term, we could therefore see legislation or case law diverging from some of the more restrictive aspects of EU-derived rules – such as on holiday pay calculations, holiday carry-over and working time record-keeping – to permit employers more flexibility without undermining workers' rights. Watch this space…

Updated A&O Guidance – and Happy Holidays

Holidays might be an escape, but there is no escaping the fact that holiday pay rules are complicated. Our updated guidance 'Holiday pay – where are we now?' provides an overview of the rules and of recent developments. Please click **here** to access this.

Wherever you are holidaying, we wish you a happy and re-energising break.

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