

# Economic freedom versus employee protection: reforming the Transfer of Undertakings Rules

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In this article the authors attempt to expose the dynamics behind the proposed reforms to the Acquired Rights Directive (hereinafter referred to as ARD) and the underlying legal and policy issues of the phenomenon of business transfers.

In an era of market flexibility, the increased capital mobility and the elimination of tariff and non-tariff protection have resulted in an ever-growing corporate interface. Fuelled by growth aspirations, as a result of rationalisation or in order to survive, businesses change hands, merge, amalgamate and create a flux economic environment. Such an environment can create a great deal of concern to employees, as they are often on the receiving end of any business re-organisation. The ARD has sought to counterbalance any adverse socio-economic effects arising out of transfers of undertakings.

## INTRODUCTION – THE STATUS QUO

The original ARD 77/187 EEC was designed to afford protection to employees in cases of business transfers and subsequent changes of employers. The basic principles of the Directive can be summarised in the following points:

- the contracts of employment, alongside with all rights, duties and obligations of the transferor (the current employer) are transferred automatically to the transferee (the new employer) (except certain rights under continuous occupational pension schemes);
- the transferor or the transferee may not lawfully terminate contracts of employment, unless the termination in question is the result of economic, technical or organisational reasons and the employer has acted reasonably under the circumstances;
- the transferor and the transferee must inform and consult representatives of the employees in relation to the legal and socio-economic implication of any transfer and in relation to the measures and proposals envisaged to deal with employees affected by the transfer in question.

## THE IMPACT OF THE ARD ON THE MARKET

### *The ARD within the legal and policy arena*

The impact on the market place has been considerable. Employers involved in business expansion were faced with the potential of additional obligations and costs. These costs were twofold. First, the costs of staffing liabilities absorbed from the transferor business, and secondly the additional administrative and legal costs in adhering to the regulations. In both cases, the costs could be unpredictable, adding an uncertain and often unquantifiable financial risk to the deal.

In relation to staffing costs, preserved terms and conditions under Article 3 meant staff transferred might be more expensive to retain than existing employees of the transferee. Consequential difficulties of amalgamating the two sets of workforce into the most efficient single unit were not aided by the lack of clarity of the law in post-transfer situations, in particular the extent of the defence of an economic, technical and organisation reason under Article 4(1). Staff morale, retention of key personnel and productivity, for both sets of workers, could be affected, either by disparity of terms, or uncertainty as to the future. In addition an extra administrative burden might arise in operating the disparate sets of terms and conditions.

Additional staff related costs might also have to be borne by the transferee, where any dismissals arose as a result of the transfer. Whether such dismissals were by the transferor or transferee, it was the transferee who met such liability under the ARD, unless the employer could demonstrate the confused defence.

Finally, in relation to staff costs, the ARD gives rise to the potential for more latent liabilities. Any liabilities in relation to

employment transfer across, which could include unpaid wages, personal injury claims or even sex discrimination claims. It is essential for the transferee to be aware of this hidden potential cost. The original ARD placed no obligation on the transferee to disclose such claims (and in any case, the transferee might not be aware of such, since claims might not be issued until after the date of transfer, where the events occurred before the transfer but within the relevant limitation period, which for contractual claims could be six years). The transferee must then make inquiries as to any such claims (bearing in mind they might not yet be visible) and re-negotiate the purchase price, or other terms of the deal, accordingly. Alternatively, an indemnity clause could be sought and agreed. However, this may be impossible where the transferee business is facing financial difficulties and even where it is possible, should the need arise, there would then be the cost and time and difficulties of enforcing such a clause.

In relation to administrative and legal costs, the complexities and uncertainties of the ARD often meant employers need resort to costly legal advice in the handling of the transfer, not to mention the not unlikely possibility of litigation. In addition, employers face the administrative burden of the consultation requirements, which induces the additional concern for employers of the leaking of commercially sensitive information, especially where competitors might also be interested in the transfer opportunity.

With the uncertainties of the ARD and its transition into UK law via the *Transfer of Undertakings (Protection of Employment) Regulations* (TUPE, SI 1981/1794), litigation was prolific. The results were not always clear or seemingly consistent. Employees brought claims concerning the effect of the law. They challenged changes to their terms and conditions post transfer. They sought clarification of what employment linked liabilities transferred across. They sued both transferee and transferor where they were dismissed in connection with the transfer and sought clarification on allocation of liability. Cases met with mixed success. (The UK Government was itself issued with compliance proceedings by the European Commission for failure to implement the ARD properly).

Employers disputed the most vexed and contested and seemingly ever broadening legal question; when was there a relevant transfer, so that the law applied. The ever-widening net of the judicial throw of the law was double edged for employers. The disadvantage was that the provisions seemed to apply to almost any transfer situation. The advantage was an apparent clarity with a developing assumption that the law would apply and so negotiations could occur on that stable, if uncomfortable, base. However, this apparent stability was rocked by a shock judgment of the ECJ, in *Suzen v Zehnacker Gebäudereinigung GmbH Krankenhausservice* (C-13/95 [1997] ICR 662). Here a school, which had contracted out, its cleaning, awarded the contract on its renewal to a different private contractor.

On previous case law, it was surprising that this case was even referred to the ECJ, since most commentators would have stated the issue had clearly been decided in previous judgments and that this would undoubtedly amount to a transfer. However, the ECJ, in what was not its most lucid moment, suggested that this might not amount to a transfer. The judgment was unhelpful in its lack of clarity, its failure to reconcile previous judgments, and the resulting uncertainty it has caused. Employers and employees were thrown back into confusion where there is a loss of a service contract, a not uncommon occurrence in the current economic climate. This led to a string of subsequent case law, both at domestic and EC level, seeking clarification of when a loss of service contract would or would not amount to a transfer. The ripples of *Suzen* can still be felt today.

In addition to the crucial test of what amounts to a transfer, there were supplementary issues of concern to employers such as the allocation of liability for dismissals between employers. When was a dismissal for a reason connected to the transfer, rather than for a reason connected to a pre-existing financial state of affairs? When could the employer change terms and conditions post transfer? What was the extent and application of the economic technical and organisational defence for dismissal? The answers to all these questions were not always clear or consistent and left uncertainties with which employers and employees had to contend in practice.

The lack of clarity-pleased no one. Employees were uncertain of their protection and employers unclear or overwhelmed in relation to their liabilities. The danger then arose that employers would be deterred from taking on other businesses. Competition would be stifled and businesses facing financial ruin would be left to collapse without rescue.

Industry, whilst supporting the general aims of the Directive, has lobbied for change. The CBI has stated its concerns relating to business efficiency, clarity and certainty. In particular it has expressed concern at the broad catch of the regulations. It would prefer to see the exclusion of straightforward contracting, where a business loses a single customer, or contract. In addition, it would like for the transferee to have freedom to re-negotiate transferred employees' terms and conditions post transfer. In relation to insolvency, it would prefer for any type of insolvency to be excluded. It would not wish to see the law extended, for example to include pensions, or so as to apply to share takeovers. Finally, the CBI has recognised the particular concerns of public sector workers transferred from the public to the private sector. Industry agrees that these concerns need be addressed whilst emphasising that any measures must also be workable for contractors.

### ***The ARD and the public sector***

In relation to the public sector, it was not always clear how far the ARD operated. Initially the UK Government,

then Conservative, published guidance indicating that the law did not apply to its compulsory competitive tendering process (CCT). This was subsequently proven wrong by judgments of both the ECJ and domestic courts interpreting the law to the contrary. The Government had been anxious that the law should not apply for fear that this would wreak havoc with its efficiency drive in public services, where a more efficient tender by a private sector firm was often based on less favourable staff terms and conditions. Suddenly, tenderers were faced with the option of taking on public sector staff on existing generous terms and conditions, or else picking up the bill for dismissal claims. Bids had to be re-costed and rewritten on the basis that the transfer provisions might bite. The Government also had to re-write the *TUPE Regulations* and amend the definition of a transfer so as not to exclude non-commercial organisations in compliance with the interpretation accorded to the ARD. In spite of these fears, CCT continued, albeit restrained under the shadow of the ARD, and persists still in its revised form of best value under the now Labour Government (and indeed has increased under the Labour Government with the Private Finance Initiative and public and private partnerships). The ARD continues still to suffer from the judicial judders, with, *e.g.* more recent cases refining the application of the provisions in the public sector where there is a reorganisation of administrative functions within public bodies, rather than contracting out. However, the application of the law to the question of initial outsourcing, or first-generation transfers, and the periodic reshuffling of such contracts, or second generation transfers (whether to a second private firm or back in-house), *i.e.* the interplay between public and private sector, remains a major issue for employees and employers alike.

### **The ADR and public procurement**

The transfer of undertakings in the context of public sector took another twist with the evolution of EC public procurement law and particularly the Public Services Directive. The compatibility and complementarity of the two regimes appeared questionable. The ARD has as its main objective the protection of employees in cases of transfer of undertakings. On the other hand, the aim and objective of the public procurement regime is to maximise savings for the public sector and enhance competitive trends in intra-community trade of services, without discrimination on nationality grounds and preferential treatment. The original ARD proclaimed its inapplicability in cases where the undertaking was not in the nature of a commercial venture; this proviso was interpreted as exclusive of contracting out by government. However, the ECJ reversed such a limitation in its landmark case C 29/91, *Dr Sophie Redmond Stichting v Bartol*, [1992] IRLR 369.

Thus, it became apparent that contracting out by government was covered, and a transfer of an undertaking may take place where the government contracts out to the

private sector a function previously carried out in-house and vice versa, *viz.* where the contracting authority takes back in-house a service formerly contracted out. The exact circumstance in which a transfer of an undertaking through contracting out occurs depends upon the transfer retaining its identity (Case C 382/92, *Commission v UK*, [1994] ECR I-2435). However, the 'retention of identity' test can only be satisfied when the undertaking transferred represents *substantially the same or similar activities*, (Case C 392/92, *Schmidt v Spar und Leihkasse der fruherer Amter Bordersholm, Kiel und Cronshagen*, [1994] ECR I-1311), as well as it relates to a *stable economic entity* (Case C 48/94, *Rygaard v Stro Molle Akustik* [1995] ECR I-2745).

The application of the ARD in public procurement contracts has received a fair deal of criticism to the extent that it could impose a significant obstacle to the integration of public markets. There is a serious debate at the moment relating the compatibility or mutual exclusivity of the two regimes. The ARD regime should not be viewed as a mere 'transfer' of employment responsibilities from the demand side to the supply side within public procurement contracts.

### **Voices for concern and change**

A prime concern of the Unions, in particular in relation to public private outsourcing, has been the exclusion of pensions from protection under the original ARD. If the purpose of the Directive was to safeguard employees' rights, they argue, why should a right as important as a pension scheme be excluded. They have campaigned for the inclusion of pensions, arguing strongly that efficiency savings of the private sector have been made at the cost of (indeed some TU officials refer to 'stealing') pension rights of employees. They further argue that employers are benefiting at the cost of the welfare state and that this detracts from the Government drive away from reliance on the state.

The Unions (particularly in the United Kingdom) have expressed additional concerns about the ARD. One concern, in common with the CBI, has been the lack of clarity on the definition of what amounts to a transfer. However, unlike the CBI, they are concerned that the law should apply in relation to loss of contracts. Post *Suzen*, the TUC is fearful of a potential loophole which enables transferees to avoid the operation of the law by refusing to take on any staff or assets of the previous employer, two key indicia of the test of a transfer. In addition, they are concerned at the more recent case law suggesting the non-application of the ARD where a reorganisation occurs within public bodies. In both these scenarios, they wish to see the law amended to ensure the law does apply. They have also campaigned for improved consultation and co-operative involvement of employee representatives during a transfer. In relation to insolvency situations, the TUC are anxious that employees should not be excluded from protection, whilst recognising that employers and Unions may need to re-negotiate staff terms and conditions in order to save jobs in

these situations. Finally, they wish to see the law extended to include transfers by share purchase. At present this is not included on the basis that there is no legal change in employer, since the company legal personality remains static. However, the reality of a change in share ownership may often mean a shake-up for staff, which the TUC feels warrants protection equal with other forms of transfers.

### THE PROPOSALS FOR REFORM

A Consolidated version of the ARD was adopted in 2001 and *inter alia* provides Member States with a flexible package to implement domestically. The revised Directive provides for discretion for Member States in four major categories:

- (1) to allow independent employees' representatives to negotiate changes to terms and conditions in order to save jobs when the undertaking of an insolvent employer is transferred;
- (2) to waive any outstanding debts of the transferor in relation to the employees, so the transferee would not be disadvantaged;
- (3) to ensure that the transferor notifies the transferee of all the rights and obligations that will be transferred in a relevant transfer; and
- (4) to include occupational pension rights within the terms and conditions that pass from the transferor to the transferee in a relevant transfer.

The revised Directive has made a number of critical amendments to the existing regime. These are detailed below:

#### *What does constitute a transfer of an undertaking: a cry for legal certainty*

The definition of transfer of undertakings has been the subject of extensive litigation at national and European level. A plethora of cases have shed light on the terminology used by the original Directive on the meaning of transfer of undertakings. The revised Directive [Article 1(1)] gives for the first time an explicit definition of a transfer of an undertaking. There is clarity over the constituent elements of a transfer such as: i) the economic entity must retain its identity and ii) it must represent an economic activity of central or ancillary nature. There is also explicit provision of the applicability of the rules to transfers of undertakings occurring in the public sector (contracting-out or outsourcing), although administrative reorganisations or transfers of administrative functions between public sector authorities are not considered transfers of undertakings.

The definitions are incorporating the rhetoric of the European Court of Justice case law, where the application of the Directive has been tested against private and public sector transfers. It is intended that the definition of what constitutes a transfer of undertaking will insert a degree of legal certainty in the market place, thus cutting down unnecessary litigation. However, when Member States will

be confronted with the task of incorporating the Directive into their legal orders, certain categories of transfers could pose significant interpretation difficulties (*e.g.*, takeover transfers, share transfers, transfers within public administration, contracting-out).

#### *Occupational pensions - a thorny issue*

Rights, powers, duties and liabilities of employees in relation to membership of continuous occupational pension schemes have not been included within the terms and conditions of a transfer and therefore excluded from the coverage of the original *Acquired Rights Directive*. However, accrued rights in an occupational pension scheme are covered by the Directive and are protected in case of a transfer. The revised Directive has kept the same line regarding occupational pensions issues.

The situation, although clear in its legal basis, has caused considerable difficulties in Member States, particularly where there is a political will to deviate from the Directive in as much as to introduce more favourable conditions (which they can) than those stipulated in the Directive in their respective legal orders.

#### *Notification of information regarding employee liability*

The revised Directive provides Member States with an option to introduce provisions requiring the transferor to notify the transferee of all the rights and obligations in relation to employees that will be transferred (Article 3.2) – so far as those rights and obligations are or ought to be known to the transferor at the time of the transfer.

There is also provision for the introduction of remedies (damages) in cases that the notification obligation is breached, and in particular the possibility of joint liability between the transferor and the transferee in respect of obligations which arose before the transfer from an existing contract of employment.

#### *Dismissal as a result of a transfer - fair or unfair?*

The revised Directive has not change substantially the provisions of the original Directive relating to the termination of employment contracts as a result of a transfer of an undertaking (Article 4.1). The position is that the transfer of an undertaking, business or part of the undertaking or business shall not in itself constitute grounds for dismissal by the transferor or the transferee. Any dismissal under these circumstances should be treated automatically as unfair. However, dismissals may take place based on economic, technical or organisational reasons (ETO reasons) entailing changes in the workforce, provided the transferor or the transferee acted in a reasonable manner.

Although dismissal and termination of employment contracts as a result of transfers is well defined in its definition and interpretation (policy and legal), there is considerable uncertainty over the interrelation of the ETO

exception with dismissals whose principal reason is the transfer itself.

**The terms and conditions of employment –**

One of the most important attributes of the *Acquired Rights Directive* has been the protection it affords to employees' terms and conditions of employment that are affected as a result of a transfer. The revised Directive maintains the status quo [Article 3(1)], which provides that the transferor's rights and obligations arising from a contract of employment or from an employment relationship existing on the date of a transfer shall, by reason of such transfer, be transferred to the transferee.

There are three fundamental parameters set by the ECJ which define the scope of any changes to the terms and conditions of employment of affected employees:

- (1) Employees cannot waive the rights conferred upon them by the mandatory provisions of the Directive, even if the disadvantages for them of such a course of action are offset by advantages so that, overall, they are not left in a worse position. Nevertheless, the Directive does not preclude an alteration in the employment relationship agreed with the new proprietor of the undertaking insofar as the applicable national law in cases other than transfers of undertakings permits such an alteration.
- (2) The benefit of the Directive, therefore, can be invoked to ensure only that affected employees are protected in their relations with the new employer in the same way as they were in their relations with the original employer, pursuant to the laws of the Member State concerned.
- (3) The relationship can be altered with regard to the transferee within the same limits as with regard to the transferor, on the understanding that in no case can the transfer of the undertaking itself constitute the reason for this alteration.

**Transfer of undertakings and insolvency proceedings**

The revised Directive, influenced by judicial precedence of the ECJ, indicates (Article 5.1) that unless Member States provide otherwise, the normal safeguards for employees against transfer-related changes to terms and conditions and transfer related dismissals do not apply where 'the transferor' is the subject of bankruptcy proceedings or any analogous insolvency proceedings which have been instituted with a view to the liquidation of the assets of the transferor and are under the supervision of a competent public authority.

Member States are given two options (Article 5.2) in an attempt to promote the transfer of insolvent business as going concerns. The two new options provide that:

- in cases giving rise to protection for employees at least equivalent to that provided for in situations covered by

the EC *Insolvency Directive* (80/987/EEC), the transferor's pre-existing debts toward the employees do not pass to the transferee; and/or

- employers and employee representatives may, exceptionally, agree changes to terms and conditions of employment by reason of the transfer itself, provided that this is in accordance with national law and practice and with a view to ensuring the survival of the business and thereby preserving jobs.


**Representation of employees**

Article 6(1) of the revised Directive contains the following requirement, which represents a significant improvement over the original Directive:

If the undertaking, business or part of an undertaking or business which is subject to a transfer preserves its autonomy, the status and function of the representatives or of the representation of the employees affected by the transfer shall be preserved on the same terms and conditions and subject to the same conditions as existed before the date of the transfer by virtue of law, regulation, administrative provision or agreement, provided that the conditions necessary for the constitution of the employees' representation are fulfilled. If the undertaking, business or part of an undertaking or business does not preserve its autonomy, the Member States shall take the necessary measures to ensure that the employees transferred who were represented before the transfer continue to be properly represented during the period necessary for the reconstitution or reappointment of the representation of employees in accordance with national law or practice.

Finally the revised Directive provides for three minor changes relating to issues on information and consultation of employee representatives.

**CONCLUSIONS**

Considerable improvements have been made in both law and policy fronts. The ARD in its revised form intends to insert an element of clarity and certainty into an environment of constant change in the business arena. Entrepreneurial freedom should be counterbalanced with employee protection, wherever possible, in order to ensure a seamless transition in business re-organisations. The revised Directive has taken these parameters into careful account. It remains to see how final document will be implemented at national level and how governments will incorporate the ARD provisions into their legal and policy orders. 

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