

**INSOLVENCY, EMPLOYMENT PROTECTION  
AND CORPORATE RESTRUCTURING: THE EFFECTS OF TUPE**

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## **Abstract**

The statutory protection currently provided by UK law to employees during transfers of undertakings and other restructurings has been criticised on the grounds that it undermines insolvency procedures and interferes with the 'rescue' process. We present an analysis which suggests that granting employees *contingent control rights* may be an efficient means of recognising their firm-specific human capital. Case-study evidence shows that while in some situations employment rights may obstruct reorganisations, in others they allow employee interests to be factored into the bargaining process so as to enhance the survival chances of enterprises undergoing restructuring. The law functions best when effective mechanisms of employee representation are in place and when the conditions under which employees' acquired rights can be waived in the interests of preserving employment are clearly specified. When these institutional conditions are met, employment law performs an economically-valuable role in expressing the interests of employee-stakeholders in the firm.

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# INSOLVENCY, EMPLOYMENT PROTECTION AND CORPORATE RESTRUCTURING: THE EFFECTS OF TUPE

## 1. Introduction

The past decade has seen an intense debate on the merits of the 'stakeholder' view of the corporation. According to this, the claims and interests of non-shareholder stakeholders - employees, creditors, customers and suppliers - are inadequately represented in the present system of corporate decision making, with potentially adverse consequences for corporate performance (Blair, 1995; Kay and Silberston, 1995; Deakin and Slinger, 1997; Kelly and Parkinson, 1998; Blair and Stout, 1999, 2001). Alongside this debate, scholars and policy-makers have argued over the objectives and purposes of insolvency law. Should insolvency law, as some insist (Jackson, 1986), confine itself to protecting the interests of creditors, or should it recognise a wider set of purposes including the 'rescue' and rehabilitation of failing enterprises (e.g. Warren, 1987, Belcher, 1994)? These two debates converge on the issue of stakeholder rights during restructurings (that is, transfers of business, insolvencies, and large-scale redundancies). In the UK context, the statutory protection currently granted to employees during restructurings, and in particular that provided by employment protection legislation in conjunction with the Transfer of Undertakings (Protection of Employment) Regulations 1981 (or TUPE), has been forcefully criticised on the grounds that it undermines insolvency institutions and procedures and interferes with the 'rescue' process (Collins, 1989; Frisby, 2000). In this paper we assess this claim and evaluate more generally the impact of employment protection legislation on processes of corporate restructuring.

We first offer a theoretical framework for understanding the claims of employees, as stakeholders, on the assets and income streams of the firm. We suggest that employment protection rights such as those contained in TUPE and related aspects of employment legislation are best thought of, by analogy with creditor rights, as *contingent* claims

to *control* of corporate assets (Armour and Whincop, 2001). What this means is that employees have claims which are akin to property rights in relation to the enterprise, in the sense of binding third parties, but which mostly lie dormant. Their activation is contingent upon the occurrence of a particular event, such as a business transfer or similar restructuring, which puts directly at risk the relation-specific investment which employees have in the firm. Once they are triggered, these property-like claims may enable employees to enter the process of bargaining which goes on during a restructuring, in such a way as to alter fundamentally the nature and outcome of that process.

We then present empirical evidence, drawn from qualitative case studies, which throws light on this hypothesis and which helps us to form a view on the efficiency implications of such effects. We suggest that the impact of employment protection legislation on insolvency procedures is, in practice, considerable. In some cases, it can be seen to have negative implications for efficiency and welfare, in the sense that it leads to the failure of reorganisations which might otherwise have preserved employment. To that extent, the arguments of TUPE's critics are justified. In other cases, statutory support for employee voice has enabled the costs of dismissal for employees to be factored into the bargaining process, in a way which has led to positive outcomes for the survival of the enterprise as a productive unit. Here, statutory support for employment rights can be seen to fulfil a role identified for it by stakeholder theory, namely limiting the scope for destructive reorganisations which generate financial gains for shareholders and managers only by extracting rents from employees and other long-term stakeholders (Shleifer and Summers, 1988; Winter, 1993).

The economic consequences of employment protection laws, then, are not clear-cut. In terms of their effect on the enterprise, they depend on the context in which they are applied and on how they interact with the often informal norms and processes of corporate culture. The British experience suggests that when employment protection laws such as TUPE are imposed upon well established insolvency

procedures, in particular those associated with the institution of receivership, some degree of mismatch is unavoidable. This does not mean, however, that the overall efficiency implications of such laws are negative. While some jobs will be lost as a result of TUPE, others will be saved. There are wider implications of the clash between employment and insolvency law in this area. In its essence, this is an argument about the perennial question of corporate governance: who owns what in the enterprise? As we show in this paper, the idea of employee ownership, conventionally regarded as being on the margins of corporate governance (Hansmann, 1996), is not as problematic as many seem to think, either as a normative basis for law reform or as a positive description of present legal reality.

We develop these themes in the following order. Section 2 below outlines the concept of contingent control rights in insolvency, and explains its application to employment protection law. Section 3 outlines our case study evidence. Section 4 concludes.

## **2. Employee governance? Corporate governance, insolvency, and employment protection**

### **2.1 Employees and residual claims**

Margaret Blair (1995) has presented a forceful case for granting greater 'ownership' rights to employees. The crux of the argument (1995: 235-275) is that employees make significant contributions to the generation of a firm's quasi-rents through the development and use of their firm-specific human capital. This gives rise to a classic hold-up problem, with threats of dismissal and/or strikes reducing the amount of quasi-rents which can actually be generated. Shareholder control can lead to inefficiencies *ex post* where shareholders decide to close the firm rather than pay employees' quasi-rents, and *ex ante*, where employees decline to make necessary investments in developing firm-specific human capital.

Writing from a UK perspective, but in an essentially similar vein, Gavin Kelly and John Parkinson (1998) also argue that orthodox contractarian scholarship on the firm does not sufficiently acknowledge the degree of residual risk borne by non-shareholder claimants. According to Kelly and Parkinson, (1998: 186) employees who are preparing to invest in firm-specific human capital will want a variety of protections: (i) continuity of employment, allowing them to continue to obtain a return on their firm-specific investment in circumstances when the firm might otherwise opportunistically terminate their employment; (ii) maintenance of an 'equitable' share in rents; (iii) and good management, to ensure overall rents are maximised.

It is clear that simply according employees some form of claim to residual *returns* will not, by itself, be sufficient to protect employees' interests. Without some form of control right—a right to direct how decisions concerning the management of corporate assets should be taken—giving a share of residual returns to employees would simply worsen managerial agency problems. However, Kelly and Parkinson argue that a governance-based solution - one that addresses the issue of residual control rights - is essential to protect firm-specific human capital. A variety of arguments have been put against this position.

First, it is possible to argue that employees' interests can be adequately protected by contract, or at least *more* adequately than is the case with shareholders: '[u]nlike... employees, shareholders do not negotiate compensation schedules in advance of performance. Rather, shareholders bear the costs of abnormally good or bad corporate performance because they receive compensation only after fixed claims are paid.' (Macey, 1989: 180).

One variant of this argument is that the law should confine itself to enforcing those terms of *express contracts* which grant employees income and/or job security rights in the event of restructuring. In the US, the employment-at-will rule, which denies legal force to most aspects of workplace and other potential sources of contractual terms

and conditions (see Rock and Wachter, 1996), makes this solution inherently problematic. In the British context, with no similar presumption of non-enforceability, express contracting over job security for employees is not at all uncommon, in particular in the form of procedures governing discipline and dismissal, and empirical studies also report evidence of voluntary agreements for consultation over corporate restructurings and reorganisations (Brown, Deakin, Hudson, Pratten and Ryan, 1998; Brown, Deakin, Nash and Oxenbridge, 2000).

However, it is unlikely that any express agreement could provide an exhaustive account of the expectations of the parties to long-term, incomplete employment contracts. In the UK context, most express employment contracts are standard-form in nature, and tend to follow a pattern pre-set to a large extent by legislation and by collective bargaining. Empirical research shows that, even in a comparatively deregulated labour market such as the British one of the mid-1990s, individual bargaining over contract terms between employers and employees is very rare below senior managerial level (Deakin, 1999, 2001). This is in line with the suggestion of contract theory that there are adverse selection and moral hazard problems, on both sides of the contract, in customising standardised employment terms. Severe informational asymmetries make it infeasible for individual workers, for example, to seek to bargain for job security clauses when these are not offered routinely by employers, for fear of the potentially negative signal of job quality which this sends to the employer; employers, likewise, may be reluctant to offer job security guarantees in a market where employment at will is the norm, since by doing so they may disproportionately attract less well qualified labour. The result is a sub-optimal equilibrium in which contract terms do not fully reflect the parties' underlying preferences (Levine, 1991; Sunstein, 2000).

Even the severest critics of stakeholder theory accept that, because of contractual incompleteness, the courts should also take some account of *implicit contracts*, that is to say, inchoate agreements, social norms and shared understandings between the parties to the employment

relationship (Macey, 1989). Opportunistic breach of implicit contracts is recognised as one possible source of purely distributional gains which may ensue to managers and shareholders as a consequence of restructuring (Shleifer and Summers, 1988). Empirical research in the USA shows that employees have expectations of job security which are greatly in excess of the legal rights which are allowed to them by the rule of employment at will (Kim, 1999; Sunstein, 2000). This implies that, quite independently of the legal position, the parties to the employment relationship recognise the importance of social norms which stabilise the relationship and encourage both sides to make investments in formal skills and/or tacit knowledge which can only be realised over the long term.

Does it follow that courts (and possibly legislatures) should be prepared to regulate corporate decision-making in such a way as to protect these expectations? For adherents of a contractarian understanding of the corporation, complete enforcement of implicit contracts would be inappropriate. The very point of implicit contracts is that they can be overridden, if necessary, in the overall interests of the enterprise. Imposing legal restrictions on employers would, from this point of view, simply bring us straight back to the familiar problems of multi-party governance. At best, then, employment protection laws simply shift wealth around, without increasing overall welfare. At worst, they would upset efficient allocations of residual claims. According to Macey (1989: 180),

‘Legal rules that purport to “protect” non- contracting parties from the effects of fundamental corporate change often simply rearrange relationships previously agreed to by the parties involved with a firm. These rules tend to reduce the overall value of firms that must comply with them. For example, if a legislature unilaterally gives rank-and- file workers a right to prior notification of a layoff or plant closing, the workers will benefit only if, to retain that right, they will not have to give up something worth more than the right itself. The price of the forced “purchase” of a right to notification may take the form of



lower wages, reduced pension benefits, or a reduction in the overall size of the workforce. Similarly, we can easily see why employees do not bargain for rights to assume control of their employers' firms when the firms become insolvent: such rights would give workers a strong incentive to drive their employers' firms into insolvency and thus would carry a considerable cost.'

This restatement of the argument against employee governance is open to objection on several grounds. Firstly, the pre-existing arrangement of rights cannot safely be assumed to be 'agreed to by the parties involved with a firm'. The scope for express agreement is comparatively small by comparison with the role played within employment by social norms and corporate culture, and by standardised contract terms. It is just as possible that express agreements - or the lack of them - on job security reflect conventional understandings and entrenched assumptions on either side, as they do the preferences of the parties. Secondly, granting governance rights to employees would not reduce the value of the firm if it thereby induced employees to make wealth-enhancing investments in firm-specific human capital which would not otherwise be made. Thirdly, workers would have no incentive to drive the firm into insolvency if they had relation-specific capital at stake in its survival.

However, it is still the case that courts may encounter insurmountable difficulties in seeking to identify the informal norms which underpin the relationship in question, and, *a fortiori*, to determine whether or not a breach has occurred. These problems of *verification*, betraying the limits of the utility of courts as a substantive governance mechanism, are thought to be one of the principal sources of incompleteness in contracts. As such, the 'new property rights' theory of the firm argues that in contrast to the enforcement of contracts, corporate governance is better understood in terms of demarcating spheres of 'residual control' (Hart, 1995). The emphasis is thus procedural rather than substantive (Deakin and Hughes, 1999). Whilst the limitations of court-based governance may be good reason for not exhorting courts to attempt complete enforcement of implicit

contracts, it does not follow that claims for employee *control* rights are thereby rebutted.

A second argument against the conferral of residual control rights upon employees concerns the *relative costs of control*. In short, the identification of multiple relation-specific investments in the firm is only the beginning of the problem. Efficiency may still favour allocating residual control rights to one particular group. This would be so if it had the effect of reducing what Henry Hansmann (1996) calls the 'internal governance costs' of the firm. He argues that an essential consideration here is the degree of homogeneity of interests among the class of those with residual claims. On this basis, rules which allocate control rights across a range of different stakeholder groups with widely-diverging interests will not form a stable basis for corporate governance:

'because the participants [in the firm] are likely to have radically diverging interests, making everybody an owner threatens to increase the costs of collective decision making enormously. Indeed, one of the strongest indications of the high costs of collective decision-making is the nearly complete absence of large firms in which ownership is shared among two or more different types of patrons, such as customers and suppliers or investors and workers' (Hansmann, 1996: 44).

Taking up this theme, Bernard Black (1999) suggests that the capacity of a particular claimant group to exercise residual control rights is more important than the nature of the claim, that is, the degree of risk to which the group in question is exposed. Employees are unsuitable as residual claimants in most contexts since they are not good monitors, lacking the time and resources to keep management under review. Nor can they allocate their rights to better monitors, since they cannot easily assign job-specific rights to others. In practice, shareholders can act as delegated monitors for employees. This is preferable to a system of overlapping ownership claims which would give rise to dangers of deadlock as each side prepared to exercise a

veto over change. As a result, '[t]he rule that employees neither vote nor receive contractual control rights... emerges as an imperfect accommodation to a complex world' (1999: 9).

In short, the norm of shareholder primacy is restored through a more precise identification of the comparative governance costs of different arrangements. Shareholders do not become the residual claimants because they bear the biggest risk. The truth is just the reverse - shareholders have most at risk *because* they are the residual claimants. They are said to occupy this position because, relatively speaking, their internal interests are more homogeneous and more easily manageable than those of other stakeholder groups.

A third argument, closely related to the second, runs as follows. If a grant of residual control rights to employees were efficiency-enhancing, then firms would have an incentive to offer such rights by contract to employees so as to induce them to make such firm-specific human capital investments. The fact that such rights are commonly not granted to employees is therefore suggestive that in most cases it is not efficient to do so.

To recapitulate: in order to make a claim for the protection of employee control rights, it is necessary to show how they can be granted without creating excessive internal governance costs, due to conflicts of interest between employees and other stakeholders, and between different groups of employees. Secondly, it is necessary to show that such protection is granted voluntarily by firms, or to provide some account of why this does not happen.

Blair and Stout (1999) present a stakeholder-oriented argument which responds to these points. These authors conceive of the firm as a *nexus of firm-specific investments*. Building on Holmstrom (1982) and Rajan and Zingales (1998), they argue that members of a production team each of whom is required to make a firm-specific investment may prefer to allocate *control* over the relevant assets and apportionment of quasi-rents to an *outsider*. The idea is that this may

be cheaper than *ex ante* apportionment (leading to rigidity and underinvestment) or *ex post* bargaining (with its associated costs). The outsider therefore has broad discretion so as to enable it to further the team's *overall* goals. This model maps well, they argue, onto the structure of the law of public corporations in the US. It implies that the board acts as a *mediator* between the claims of competing stakeholder groups, rather than according priority to shareholders as the 'residual claimants'.

The response offered in this paper focuses on a different aspect of the problem, although it is not inconsistent with this view. We draw an analogy with the protection of creditors' firm-specific investment to show that it might be possible to grant employees governance rights to protect their interests *which are only activated on the occurrence of certain contingencies*, thus minimising the costs of sharing control.

## **2.2 Insolvency procedures and contingent control rights: creditors and employees**

As has been noted, recent scholarship on incomplete contracting and the theory of the firm views the allocation of 'residual control rights' as the key to governance arrangements. Viewed in this light, a standard debt contract is no more than the *sharing* of residual control rights between debtor and creditor, on a *sequential* and *contingent* basis. Provided that the debtor continues to make repayments to the creditor, then the debtor retains control rights. However, should the contingency of default occur, the creditor has the power to have the debtor's asset(s) seized and sold to pay the debt. In the pared-down world of the incomplete contracting models, residual control over the assets shifts, in default states of the world, from debtor to creditor (Hart and Moore, 1997). This protects the creditor's investment, however, because so long as the value of the asset is greater to the debtor than the cost of the outstanding repayments, the debtor will continue to repay. Whilst the creditor's control right remains dormant,

it nevertheless exerts a credible threat over the debtor such that repayments will be induced. Furthermore, the role of the court in enforcing the arrangement is seemingly minimal: all that need be verified is that the default contingency has occurred (if it has), with a consequent mandate for the transfer of control rights.

We can now explain the analogy we draw with creditor's rights. Note that, in many discussions of 'stakeholding', creditors are considered as stakeholders distinct from shareholders and/or managers. Thus, we would expect that the same arguments against the sharing of control rights between stakeholder groups discussed in section 2.1 would also apply to sharing between shareholders and creditors. However, the solution offered by the standard debt contract is that ownership (residual control rights) is *partitioned* between the two claimants, remaining in the hands of the 'least-cost controller' (the debtor/shareholder) until and unless a contingency occurs which poses a severe threat to the creditor's investment. If all goes well, the credible threat this right confers on creditors should mean that default need not occur. Even if it does, the *benefits* of creditor control under those circumstances are likely to be sufficiently high as to outweigh the costs. Partitioning ownership sequentially upon verifiable conditions thus economises on internal governance costs, whilst maximising the protection which such rights afford to creditors.

It is well-known, however, that the enforcement of creditors' rights generates costs anew. *Ex post* co-operation problems between creditors give rise to what is now coming to be termed an 'anticommons' problem (see Heller, 1999) after enforcement, with the consequent possibility that value may be destroyed unnecessarily.<sup>1</sup> Corporate insolvency law is perhaps best understood as a response to precisely this problem, collectivising creditors' governance rights at precisely the moment when the costs of their individual exercise are most exorbitant (Jackson, 1982; 1986). One feature common to insolvency procedures, then, is that they *collectivise* creditors' individual rights. This can be understood as redefining individual property rights in the firm's assets as collective property rights to be

dealt with by the creditors as a group. This could most obviously be implemented through a formal stay of claims, as under the ‘automatic stay’ of US bankruptcy law.<sup>2</sup> A similar effect is had upon the claims of unsecured creditors by the commencement of winding-up proceedings in the UK,<sup>3</sup> or on those of all creditors by the bringing of a successful petition for administration.<sup>4</sup> In addition, security interests can also be viewed as effecting a transformation of individual property rights into a unified asset pool (Picker, 1992), and it is clear that the English administrative receivership procedure, although formally an enforcement mechanism employed by a single secured creditor, has a collectivising role to play in this way (Buckley, 1994; Armour and Frisby, 2001).

This consideration of insolvency law’s function in protecting creditor investments shows that it is possible for residual control rights to be ‘shared’ in a more efficient manner than simply in parallel (as shareholders do). It also gives us cause to speculate as to whether contingent *employee* control rights, exercisable only under circumstances where employees’ firm-specific human capital investments are in danger of expropriation, might offer a response to the second argument in section 2.1. This leads naturally into a consideration of the third argument: why we do not observe firms granting such rights to employees voluntarily. Our response to this also draws on the functions of debtor-creditor law.

The ‘new property rights’ theory of the firm offers a robust account of how the sharing of entitlements to residual control over assets can act as an important mechanism of governance. However, it does not fully explain the role of *property law* in defining the ways in which such sharing of entitlements to assets can be given *proprietary* status (Armour and Whincop, 2001). To see this, return again to the example of the debt contract. The creditor’s threat can be devalued should the debtor alienate or destroy the asset supporting the arrangement, or grant further debt claims against it. The creditor is protected to a certain extent by fraudulent conveyance law (Heaton, 2000): should the debtor become unable to pay its debts, then further alienations for

less than full value will be voidable. The creditor can opt into further protection by taking a security interest in the debtor's asset *ex ante*. This will restrict the debtor's ability to alienate the asset, or to offer it to support further borrowing (Schwartz, 1989). The rules which provide this default and opt-in protection, respectively, for creditors, are rules of *property law*. By this is meant that they affect the relations of the debtor with an open-ended set of potential counterparties, and would thus be impossible to replicate by contract (Schwartz, 1997; Heaton, 2000).

In demarcating contract from property, analytical lawyers make use of the Roman law distinction between rights *in personam*—which are good only against particular persons—and rights *in rem*—which are imagined to inhere in particular assets, and which are good against whoever for the time being holds the asset. While there are derogations from most types of legal right which can claim to be *in rem*, the distinction makes a basic but very important contribution to our understanding of the role of law in a world of nonzero transaction costs. A contractual right is good against specified persons. In contrast, a duly perfected property right is good against the *residual* set of all possible persons.<sup>5</sup> And in situations where entitlements to assets are shared, a proprietary claim against will therefore bind *all the potential parties to whom the other 'co-owner' might seek to sell the asset*. This greatly reduces the second-order moral hazard problem of ex-post contracting.

It is coming to be realised that one of the most important functions of corporate law is to partition collective entitlements to assets in such a way as to protect governance arrangements in this way (Hansmann and Kraakman, 2000, Armour and Whincop, 2001). In particular, the technique used by what Hansmann and Kraakman refer to as 'organisational law' is to partition the assets against which creditors of the organisation may enforce their claims ('organisational assets') from the assets against which the personal creditors of the individuals associated with the organisation ('personal assets') may enforce *their*

claims. This involves the use of property rights which go beyond the use of contractual methods of risk allocation.

It follows that property law has what may be called a ‘pre-Coasean’ feature, in the sense of shaping the conditions for Coasean bargaining between the parties over future rights and obligations. If property law does not facilitate an outcome, it may well be that that outcome is impossible to achieve. This is because there are limitations on the extent to which different co-ownership structures are facilitated by the law; these are thought largely to be derived from the possible externalities and anticommons problems to which ‘nonstandard’ structures might lead (Heller, 1999; Merrill and Smith, 2000; Parisi, 2001). At the same time, property law may be capable of producing only constrained efficiencies; in other words a given system of property rights may fail to enable outcomes which are Pareto-superior to those which obtain in practice. Property law matters, then, since its presence (and equally its absence) can shape both the distribution of income streams between the different stakeholder groups and the overall efficiency of particular governance arrangements.

### **2.3 Employment law and contingent control rights**

The analogy drawn from insolvency law in section 2.2 allows us to offer a governance-based explanation of a number of aspects of employment law. Our explanatory hypothesis is in three parts, as follows:

1. Employment protection law can be understood as providing contingent control rights to employees which are triggered by a significant change in the form of the enterprise threatening their firm-specific human capital, in particular, in the context of TUPE, the sale of the business undertaking or part of it to a third party.
2. This right can be said to be in the nature of a property right when employees’ existing or ‘acquired’ rights arising from employment



automatically bind third parties, such as (in relation to TUPE) the purchaser of the undertaking.

3. Employment law operates to collectivise the employees' divergent interests in such a way as to overcome the governance costs of renegotiating the terms of employment contracts, by vesting these negotiation rights in the designated employee representatives who, for this purpose, have monopoly representation rights.

We will expand on each of these points in turn.

1. *Employment protection law provides contingent control rights to employees which are triggered by a threat to employees' firm-specific human capital.*

Redundancy can have far reaching effects on the welfare of employees. Studies consistently show that workers who lose employment in this way on average take many years to recover their previous level of earnings, and that many never do. Displaced workers have a subsequent 'wage path' significantly below those of workers who are not made redundant (Schultze, 2000). A variety of effects are at work here. Employees may have firm-specific skills which cannot readily be deployed elsewhere. Even if skills are to some degree transferable, the effect of working in a single organisation for a prolonged period of time can give rise to a wage-specific premium which is lost when the worker is made redundant. This may derive from a worker's tacit knowledge of organisational practices, and also through the opportunities for mutual learning between employer and employee in the matching of skills and job requirements over time (Schultze, 2000: 50). Employers may also choose to reward length of service with seniority bonuses as a part of a general incentives scheme aimed at enhancing loyalty and effort in circumstances where asymmetric information makes it problematic to link wages directly to individual output (ibid., 251). For all these reasons, restructurings which result in large-scale job loss put employees' firm-specific

human capital at stake, and thereby create ex ante incentives for under-investment on both sides of the exchange.

It is not just redundancies themselves which put firm-specific human capital at risk. Certain other events - the sale of the employer's business to a third party, the outsourcing of parts of the employer's operation, a takeover or merger - do the same, since it is understood that they may presage a restructuring. A change in ownership, whether through a share transfer or through a transfer of all or part of the employer's business or undertaking, frequently implies a shift of management strategy and orientation. Takeovers, whether hostile or agreed, are often associated with large-scale redundancies both before and after the merger of the two companies takes place. Business transfers of the kind which occur when a business is sold as a going concern to a third party provide an occasion for the new employer to reassess the employment requirements of the undertaking. Outsourcing may proceed on the basis that the services in question will be provided in future by the labour force of the external supplier, leaving the workforce of the client facing redundancy.

When creditors' interests in the firm are directly at risk as a result of its impending failure or its inability to service its debts, insolvency law, as we have seen, provides a number of mechanisms for enabling creditors to exercise control rights which have the effect of excluding shareholders from access to assets and income of the firm. Where this occurs, creditors become, in effect, the firm's residual claimants. How far is a similar process at work when the firm-specific interests of employees are put at risk by a restructuring?

The mechanisms of employment law are not dissimilar, in terms of their function, to those of insolvency law. Under UK employment legislation, employees who are made redundant are entitled by statute to receive an award of compensation;<sup>6</sup> they may also obtain compensation for unfair dismissal if the redundancies were carried out on the basis of an unfair selection process (reinstatement, while possible in principle, is very rarely awarded in this context).<sup>7</sup> These

rights go some way to recognising the economic significance of redundancy for employees, in particular to the extent that they are augmented for employees with greater seniority, but they do not provide a basis for challenging the decision for redundancy itself. In that sense, they do not touch on the issue of governance. In addition, however, when an employer is contemplating large-scale redundancies or is about to effect a commercial transaction leading to a business transfer within the meaning of TUPE, it must consult the representatives of the employees with a view to reaching agreement on ways of protecting the employment and 'acquired rights' of the employees.<sup>8</sup> Failure to consult can result in a protective award being made against the employer which contains a significantly punitive element: the employer must pay a sum equivalent to the wages or salary of all the employees affected by its breach of the law for the whole of the period during which consultation should have taken place (up to a statutory limit on 'normal' weekly earnings), on top of their existing contractual entitlements.

In the case of takeover bids, the protection is less extensive, being a duty simply to provide information.<sup>9</sup> Under the City Code on Mergers and Takeovers and also under the terms of the draft Thirteenth Directive on Takeover Bids, the bidder must state, in the offer document, what plans it has (if any) to alter the terms and conditions of employment and other existing rights of the employees. Nor is there an effective sanction, since a failure to comply with even this minimal requirement is not actionable by the employees within the framework of the City Code, since they have no standing before the City Panel on Takeovers and Mergers. The absence of effective protections for employees in relation to hostile takeovers is something of a lacuna in the law, given the more extensive rights provided by the law in relation to changes of ownership arising out of business transfers (see Slinger and Deakin, 2000). Nevertheless, it is notable that the Code does recognise to some degree the potentially negative implications for employees of a takeover bid being mounted.

How far do these rights equate to claims to control? From this point of view, the most significant aspect of the laws relating to information and consultation is the granting of rights of collective voice to employee representatives. These rights, like those of the creditors in relation to insolvency, lie dormant until the point when they are triggered by the employer's decision to engage on a restructuring. It is true that the remedies available to the employee representatives are in some respects weaker than those which insolvency law may provide to creditors. The employees do not have the power to oust the existing managers and replace them with their own representative, as a secured creditor may do when it exercises the option of receivership. Nevertheless, the room for manoeuvre of management may be significantly curtailed.

One possibility is that an employer's failure to observe the information and consultation rights of the employees could have the effect of nullifying the impact of the commercial transaction - the sale or outsourcing of the undertaking, for example - on the employment relationship. In other words, the purported dismissal would be ineffective; the employee would remain in employment, and entitled to receive full wages and salary, and in principle even to be provided with employment, as if the restructuring had never taken place. This would undoubtedly provide the employer with a strong incentive to observe the terms of the information and consultation law; a remedy of this kind is available in some continental systems, such as France (Didry, 2001). The English courts have refused to go this far, holding that a dismissal which is *unfair* in relation to a business transfer is not, for that reason, *void*.<sup>10</sup>

Yet the protective award, under UK law, can also have a strong deterrent effect. By doubling the salaries and wages of the workforce for a period of weeks or perhaps months, the sum owed by the employer soon mounts up, eating into the income and assets which would otherwise be available to shareholders or, in some cases, creditors. The viability of a particular managerial strategy for restructuring may thereby be undermined. At the end of the day, the

difference between the protective award and the remedy of 'nullification' of dismissal is one of degree, not one of kind.

Account should also be taken of the 'super-priority' which TUPE can confer on the employees in the event of insolvency. By requiring the transferee to take the business as a going concern along with existing liabilities to employees, TUPE imposes a cost to the transferee which directly affects the value of the business. If the price which the transferee is willing to pay is reduced by the amount of the liabilities towards the employees which it inherits, the income available for redistribution to the creditors is reduced by precisely that amount. Here, TUPE operates *ex post* to shift resources from the creditors as a group, to the employees. Viewed *ex ante*, we may say that it functions as a *penalty default*: the transferor and transferee between them can try avoid the obligations of information and consultation, but only at a high cost.

Nor is the idea of nullification completely absent from the UK law relating to transfers. In *Wilson v. St. Helens BC/Baxendale v. British Fuels*,<sup>11</sup> Lord Slynn, applying the case-law on transfers of the European Court of Justice, accepted that while UK law could not accept the notion of a void dismissal, a purported *variation* of terms of and conditions in relation to a transfer would indeed be void if it could not be shown to be for an 'economic, technical or organisational reason relating to the workforce'. The effect of this ruling is that it is *more* difficult for an employer to vary terms and conditions of employment in the context of a business transfer than it would be in other, non-transfer situations. In principle, TUPE is about the preservation of the employee's acquired rights; it cannot grant rights over and above those which the employee already had. However, TUPE, following the Acquired Rights Directive, attaches stricter rules to dismissal and, by implication, to the variation of terms and conditions, than those which would otherwise apply. In particular, the concept of an 'economic, technical or organisational' reason justifying dismissal in the context of a transfer is much narrower than the concept of 'some other substantial reason' for dismissal which the

UK courts apply in the context of non-TUPE restructurings.<sup>12</sup> This illustrates again the particular quality of the rights conferred by TUPE, namely that they offer a stronger-than-normal level of protection for employees which is triggered by the particular threat posed to their firm-specific human capital by the transfer.

*2. The rights provided by TUPE are in the nature of property rights which bind third party employers*

Insolvency law provides creditors with mechanisms for ring-fencing the asset pool of the firm against latecomer claims of third parties, thereby providing them with a degree of protection in their dealings with the firm. Employment law, likewise, contains devices for entrenching the claims of employees for protection of their firm-specific human capital. The best known illustration of this is the mechanism contained within TUPE for the novation of contracts of employment in the event of a transfer of all or part of the undertaking. The 'acquired rights' of the employee, both contractual and statutory, are automatically carried over into the employment relationship with the new employer. This is the case not just in relation to terms and conditions of employment and statutory employment rights; the transferee employer also inherits employment-related claims against the transferor, including any liabilities for failure to respect the information and consultation laws and any outstanding claims for redundancy and unfair dismissal compensation.

TUPE is a particularly strong illustration of the idea that employees have a claim on the *enterprise*, loosely understood as the managerial or organisational unity through which the human assets of the firm are brought together with its physical and financial assets. This claim cannot be overridden merely by virtue of a change in the ownership of the other assets. TUPE ensures that a change in the sale of the firm's assets from one employer to another does not unduly prejudice the employee's expectations of continued access, through employment, to *those* assets. This is another way of recognising that the employee's human capital is firm-specific in the sense of being bound up with

complementary physical assets and organisational routines. This is reflected in the test for identifying a 'relevant transfer' of all or part of an undertaking under TUPE and the Acquired Rights Directive. This is essentially concerned with whether the 'economic entity' in which the employee works 'retains its identity' after the transfer. Important considerations include the degree to which the same plant and equipment is used after the transfer takes place and how far there is some continuity of management before and after.<sup>13</sup>

Following the decision of the House of Lords in *Wilson v. St. Helens BC/Baxendale v. British Fuels*,<sup>14</sup> the transferee is not bound to take the employees of the transferor into its employment; although it will remain liable to pay unfair dismissal compensation, the dismissal itself will not be regarded as a nullity. To that extent, the property-like nature of the employees' rights is qualified; they can obtain, at best, compensation for being denied employment. The remedial structure of TUPE is therefore based on a 'liability rule' rather than a 'property rule' in the Calabresian sense of those terms (Calabresi and Melamed, 1972). Nevertheless, liabilities to employees now run with the assets of the enterprise, in the characteristic manner of a property-like claim. The compensation payable by transferees may be substantial, in particular if it is coupled with liability under a protective award for failure to inform and consult the employee representatives. In all other respects, the jurisprudence generated by TUPE and the Acquired Rights Directive is hostile to the idea that third party employers can avoid liabilities by structuring commercial transactions in a particular way. Even the 'hiving down' provisions of TUPE, which were apparently intended to facilitate the practice of selling insolvent businesses free of employment law obligations, have over time been given an increasingly restrictive reading by the courts.<sup>15</sup>

Other mechanisms are available to courts as means of ensuring that commercial forms are not used as artificial devices for shifting around employment liabilities. These include the labour law concept of 'associated employers', rules aimed at imposing employer-like obligations on the users of agency and sub-contract labour, and, on

occasion, imaginative uses of the tort of conspiracy to impose a form of corporate group liability (see Deakin, 2001). TUPE, then, is just one example of a range of techniques, albeit the one which comes closest to expressing the idea that employees have certain property rights in relation to the enterprise.

3. *Employment law vests monopoly representation rights in the designated employee representatives in such a way as to minimise collective action costs of ex post decision-making*

Insolvency law, precisely because of way in which it *collectivises* control rights, provides a mechanism for resolving divergences of interests between creditors and other stakeholders involved in the process of corporate rescue. In the same way, divergences of interest between different employees can be resolved, to some degree at least, through the employee representatives who are granted monopoly representation rights in relation to information and consultation laws. Under UK law, where an independent trade union is recognised by the employer for the purposes of collective bargaining over the terms and conditions of relevant employees, the employer must enter into consultation over redundancies or a business transfer with *that* union in respect of the workers in question, to the exclusion of all other bodies. Where there is no recognised trade union, the employer must consult employee representatives who are elected or selected under procedures laid down by legislation.<sup>16</sup>

The capacity of a recognised trade union (or several unions, if there is more than one in a given workplace) to negotiate on behalf of a group of workers with widely divergent interests with regard to a restructuring cannot be taken for granted. In practice it is often a function of that union's strength with regard to management, the degree of support it has from the workforce, and the policy orientation of its national officers (Deakin, Hobbs, Konzelmann and Wilkinson, 2000). The difficulties inherent in ensuring effective representation in workplaces where no union is present, and where employee representatives have to be elected or selected in an ad hoc way, has



also been pointed out (McCarthy, 2001). These observations may imply a need for improved statutory support for independent employee representation of various kinds, but they do not detract from the basic point, namely that the law provides a means by which the power to make a co-ordinated response to management is vested in the hands of designated employee representatives.

What is less clear is how far employee representatives of any kind are in a position to play the role we have suggested they should play in relation to restructurings. Our argument has been that employment law can be understood as operating to grant voice rights to employees which enable their interests to be taken into account in the processes of bargaining between the different stakeholder groups during insolvency or reorganisation. As we have seen, the law operates through a kind of penalty default - if the employer (or receiver) does not respect these voice rights, substantial liabilities will be incurred as a consequence.

For this claim to be borne out at the level of an analysis of the law, it would be necessary to show that the legal framework both permits and encourages this form of bargaining. On the face of it, the legal analysis is not promising for our hypothesis, since one of the cardinal points of TUPE is that the 'acquired rights' of employees are not open to renegotiation after the transfer, even by a recognised union acting on their behalf; according to the courts in the *Wilson* and *Baxendale* cases, these rights are non-waivable.

On closer inspection, this is less of a problem for our argument than it might seem. Firstly, it is clear that the drafters of the 1977 Directive intended there to be greater scope for bargaining over the acquired rights of employees than is currently the case in UK law. The Directive contained a provision permitting a Member State to allow collective agreements to vary the terms and conditions of the transferred employees after a period of one year had elapsed from the transfer (the default being that the transferee was otherwise bound by the terms of the collective agreement in force at the time of the

transfer).<sup>17</sup> It is the absence of such a derogation in TUPE that is the cause of the particular difficulty in which UK law now finds itself on the issue of non-waivable rights. Secondly, rights which appear to be mandatory in law are nearly always susceptible to some kind of bargaining process in practice. Recognised unions and bodies of employee representatives, which are initially responsible for bringing claims for the protective award (individual employees cannot do this), can make it clear to the employer that they will not do so; alternatively, after a protective award has been made, they could discourage individual employees from suing for compensation, although this may be more problematic. As we shall shortly see, this empirical analysis can throw light on how feasible this is in practice. Thirdly, the amendments to the Directive now make renewed provision for bargaining over the implementation of acquired rights, particularly in the case of insolvency. These provisions are due to come into force in UK law in the next few months.

In short, UK employment law, through a combination of substantive protection for individuals (redundancy and unfair dismissal protection), voice rights (information and consultation requirements) and devices for extending employment rights so that they run against third party employers (the novation mechanisms in TUPE), acknowledges the existence of a contingent control right for employees. The right is triggered by restructurings which imperil employees' firm-specific human capital. To that extent, employment law in the UK (and in other EU systems) recognises that employees have a property-like claim on the enterprise. This claim is independent of the structure of ownership of the enterprise, but operates, rather, in the manner of the asset-partitioning devices which are used in insolvency law to protect creditors.

According to orthodox corporate governance theory, the vesting of such a right in employees will raise the costs of ex post bargaining, threatening the stability of established arrangements. If the voices of shareholders and, in cases of insolvency, creditors, are muted in this way, corporate decision-making will be adversely affected. In

particular, it raises the spectre of *inter-stakeholder* conflict between employees and creditors in the case of corporate insolvency. To see how far this objection is borne out by empirical evidence, we will now turn to our case studies.

### **3. The effects of TUPE on restructuring: case study evidence**

#### **3.1 The range of possible effects of TUPE**

The vesting of contingent control rights could have positive or negative effects on the restructuring process. On the one hand, granting voice to employees could enable them to influence managerial decision-making in such a way as to protect investments in firm-specific human capital. On the other, multi-stakeholder governance could lead to misallocations of resources and co-ordination failures. To understand the possible range of effects in more detail, it is necessary to consider the incentives facing the different stakeholder groups and their agents during the restructuring process.

Employees' rights are of course protected in corporate insolvencies in a variety of other ways than through TUPE (see Goode, 1997; Pollard, 2000). First, in liquidation they rank as preferential creditors in right of claims for unpaid wages and holiday pay entitlements accruing in the four months prior to the commencement of the proceedings up to a maximum of £800 per employee. This entitles them to payment of this sum ahead of other unsecured creditors and the holders of floating charges.<sup>18</sup> Their preferential status also applies in receivership,<sup>19</sup> in which case assets subject to a floating charge must be applied to the payment of preferential creditors ahead of the holder of the charge, but not in administration. Second, employees of a company which has entered insolvency proceedings<sup>20</sup> also have an entitlement to claim against the state—in the guise of the National Insurance Fund. This claim is more generous, covering not only unpaid wages for up to eight weeks, but also payments in lieu of notice and any basic award of compensation payable for unfair dismissal, and any extra

remuneration due the employee under protective award under section 189 of the Trade Union and Labour Relations (Consolidation) Act 1992.<sup>21</sup> However, the rights granted under this provision are subject to a statutory upper limit.<sup>22</sup> The Secretary of State is then subrogated to the employee's claim against the insolvent employer (including, to the extent that the claim to which he is so subrogated is preferential, its preferential status).<sup>23</sup> Third, employees who continue to work for a company in administration or receivership will usually be deemed to have had their contracts of employment 'adopted' by the office-holder after 14 days,<sup>24</sup> with the result that liabilities accruing under those contracts during the continuance of the insolvency proceedings are given priority status.<sup>25</sup>

An office-holder in a receivership or administration seeking to effect a going-concern sale is under a duty to realise the best price reasonably obtainable for the assets at the time of sale.<sup>26</sup> As the company is insolvent, this duty gives primacy to the interests of creditors, who by then are the residual claimants. Thus a going-concern sale may only be achieved if the office-holder considers that this will generate a greater return than a break-up sale. *Prima facie*, this would seem to be an efficient outcome. However, as we have seen, it is claimed that TUPE has an adverse effect on the facilitation of successful going-concern sales of businesses in corporate insolvency proceedings (Collins, 1989; Frisby, 2000) by introducing distortions into this decision.

One distortion identified in the theoretical literature is that employees' acquired redundancy entitlements can worsen the purchaser's bad-state payoff. Consider that the purchaser of a financially distressed business has limited information. Hence, whilst the purchaser may be willing to offer more for the business as a going concern than the assets are likely to raise in a break-up sale, any such offer will necessarily reflect a mean expected return, averaged across good states in which the firm succeeds, and bad states, in which it subsequently fails. If the firm fails and employees are made redundant, then TUPE will mean that any acquired redundancy

entitlements the employees may have against the insolvent employer will be carried over to the purchaser. This will mean that, in the ‘bad state’ in which the firm fails, the purchaser’s position will be worsened by the amount of the redundancy liabilities, as compared to a situation in which TUPE did not operate.

Of course, employees’ acquired rights will not be at issue in all insolvencies. Whether or not they matter will depend on several variables. Let  $l$  represent the expected value of the assets sold on a break-up basis, which is assumed to be certain. Let  $\bar{v}$  be the expected value of the firm sold as a going concern to a risk-neutral purchaser. This is a probability-weighted mean across good states in which the firm prospers in the hands of the purchaser, and bad states, in which it continues to perform poorly and must subsequently be closed.<sup>27</sup> Finally, let  $e_r$  be the value of the employees’ redundancy entitlements (statutory and contractual redundancy compensation and any protective award), should they crystallise if the firm eventually fails. If a potential purchaser estimates that the bad state has a probability  $p$  of materialising (where  $0 < p < 1$ ), then they will discount the going-concern value of the assets to reflect this additional liability if it is transferred under TUPE, such that the most they will be willing to pay is  $\bar{v} - pe_r$ . It is possible to identify three separate categories of outcome, in only one of which TUPE makes a difference:

- (1)  $l > \bar{v}$
- (2)  $(\bar{v} - pe_r) > l$
- (3)  $\bar{v} > l$  and  $(\bar{v} - pe_r) < l$

In cases falling into categories (1) or (2), TUPE has no effect on the outcome. In category (1) cases, the firm is economically distressed and would close regardless. In category (2) cases, the purchaser will discount the price which they are willing to pay for the assets to incorporate the expected liability to employees should the bad state materialise. This does not prevent a going-concern sale occurring, but means that the creditors recover less in right of their claims. In effect, the expected value of the employees’ claims has been given priority to

the claims of creditors, even those with all-encompassing security (Frisby, 2000).

In category (3) cases, the transfer of acquired rights makes a difference as to whether the firm is sold as a going concern or not. In cases like this, the expected employment claims lead a rational buyer to discount the value of the value of a going-concern purchase to such an extent that they are willing to pay less than the office-holder can raise through a break-up sale.

So far, we have considered the distortions introduced by the straightforward transfer of employee (cash) entitlements to a purchaser. As discussed in section 2.3, however, employees are also granted important *process* rights in the form of entitlements to consultation, where either a transfer of undertaking or redundancies are contemplated. Should these rights not be respected, a 'protective award' may be made against the employer. Essentially, this is a form of punitive damages, doubling the employer's liability for contractual payments of wages and salaries, up to a certain statutory limit, during the period when consultation should have taken place.<sup>28</sup> In the context of a financially distressed firm, however, it may be difficult to achieve compliance with the consultation period required by statute. Office-holders must make decisions on the basis of limited information in a short space of time, and it may not be possible to provide employees anything like the normal consultation period.<sup>29</sup> This may introduce further distortions into the rescue process.

Where the firm is to be closed and the assets sold on a break-up basis, then an office-holder's failure to consult the employees about redundancies will have no, or almost no effect on creditors. The employees' redundancy entitlements as against the insolvent employer will rank only as unsecured claims. Whilst the employees will, however, be able to claim their protective award against the state in the guise of the National Insurance Fund, the latter will be subrogated to their claims against the insolvent company.<sup>30</sup> However,

as in most cases the unsecured creditors will receive nothing, this will make little difference to the creditors' position.

The position as respects redundancies where a going-concern sale is effected is more problematic. If the purchaser perceives a risk that the firm may fail shortly after the purchase, then this may lead to  $e_r$  being increased by the amount of the protective award, at least if the employees are made redundant without the statutory consultation period being respected. As a result, the price offered for a going concern purchase would be discounted further. Similarly, if the office-holder has made some redundancies, and then sells part of the business as a going concern, then a purchaser may perceive a risk that these redundancies were deemed to have been made 'in contemplation of the transfer' under the *Litster* decision,<sup>31</sup> and thereby treated as creating further liabilities for the purchaser (Frisby, 2000: 265-266). Because of the 'super-priority' of employee rights which arises from *Litster*,<sup>32</sup> this particular cost will be incurred regardless of whether the business subsequently thrives or not.

These theoretical observations generate a number of specific lines of enquiry for empirical investigation. As a preliminary matter, it would be helpful to understand the way in which practitioners perceive TUPE enters into negotiations concerning the sale of distressed businesses. Second, we should like to identify whether or not the cases falling into the hypothesised 'category (3)' actually occur, and if so, how significant this category may be in relation to the other two. Third, investigation of the possible mismatch between the 90-day (or, as the case may be, 30-day) consultation period and the rapid decision-making necessary in insolvency proceedings is called for.

### **3.2 Methodology**

The empirical findings discussed in this paper form part of a larger study investigating the functioning of insolvency procedures law and the protection of stakeholder rights (see Armour, 2000; Armour and Deakin, 2000; Armour, 2001; Armour and Deakin, 2001; Armour and

Frisby, 2001). The data were obtained in two distinct phases. The first of these consisted of 26 open-ended interviews with professionals—accountants, bankers, lawyers, turnaround consultants and credit insurers—experienced in dealing with corporate insolvencies.<sup>33</sup> Interviewees were identified using a combination of the ‘snowball’ technique and approaches made to relevant organisations. The second phase consisted of detailed investigation of thirteen case studies of particular firms which went through periods of financial distress. These firms were identified partly through responses of interviewees in the first phase, and partly through newspaper reports.<sup>34</sup> Information about the case studies was gathered principally through interviewing a further 19 subjects who had participated in these cases. Where possible, it was sought to ‘triangulate’ perspectives by meeting with representatives of more than one group. The interview data were supported by information available from Companies House, newspaper cuttings, and in some cases documentation passed to us by the participants and/or transcripts of relevant court or employment tribunal decisions.

Six of the case studies involved issues relating to the interface between employment law and corporate insolvency and form the principal data discussed in this section. They are summarised in Table 1. Furthermore, several of the phase one interviewees raised similar issues during discussions.

### **3.3 How does TUPE enter into negotiations?**

Of our first-phase interviewees, eleven had extensive personal experience of conducting, or advising on the conduct of, administrations and administrative receiverships.<sup>35</sup> When asked which issues relating to employees created difficulties for them in the context of corporate rescues, six identified TUPE as a matter of serious concern.<sup>36</sup> Those who spoke about TUPE seemed agreed that it could lead a purchaser to reduce the price they would be willing to pay for the business. This following statement made by interviewee 2 is largely representative:<sup>37</sup>



“The Acquired Rights Directive I think is bad news for employees, because it makes businesses harder to sell, and therefore jobs harder to rescue. ... [A]t the margin I’m sure there are cases where the business didn’t sell because of the burdens that the purchaser would have had to take on.”

This perspective was echoed by our interviewees in phase two, those of whom acted regularly as administrators or administrative receivers also alluded to this problem.<sup>38</sup> This is very much in keeping with the findings of Frisby (2000: 264-266), who adopting a similar methodology, interviewed nine insolvency practitioners in the English Midlands during 1998.

The three interviews with insolvency practitioners relating to our employee case studies were particularly informative with respect to the operation of TUPE. Interviewees 38 and 39 explained to us in detail how they dealt with the issue of the transfer of potential redundancy liabilities in negotiations with a potential purchaser. Interviewee 38 felt that it was better for the purchaser to be aware of any potential TUPE issue early on in the negotiations and incorporate any potential discount from that point onward, rather than have it raised on the eve of a sale where the purchaser might use it as a more powerful bargaining lever. He went on to note that he would typically make the point to purchasers that if they intended to run the business as a going concern, then there should be no TUPE liability, as there should not need to be any redundancies. However, he acknowledged that this would not be persuasive because purchasers would still be concerned about the risk that the business might fail. Interviewee 39 said that most purchasers tried initially to obtain a discount for the *entire* possible redundancy claims, to which he would respond that if the business continued to trade, these claims would not crystallise. The picture that emerges is one of both sides putting the case that favours their position best—either the full claim, or no claims crystallising—to the other, and then working towards a compromise from there. Furthermore, potential claims arising from TUPE were

just one of many ‘bargaining chips’ which the parties might be seeking to exchange. As interviewee 38 put it,

“It’s all a negotiation that depends on the strength of your hand [amongst other things], how eager the purchaser is to buy the business.”

“It’s a very debatable issue, the extent to which you lose value as a result [of TUPE]. It’s quite difficult, because of course the negotiation revolves around all sorts of issues. You know—the loss of this customer, the value of this stock, TUPE—it all sort of gets thrown in together.”

When asked whether they could think of cases where employee claims had caused going concern sales to fail, five of the interviewees were able to give examples.<sup>39</sup> Two of these became case studies E1 and E5.

### **3.4 Where TUPE stymies rescues**

Case E1 concerned a shipyard in Northeast England. Having gone through privatisation and a management buyout during the 1980s, the yard was by the early 1990s in a relatively fragile state of financial health. As part of the early denationalisation, its business consisted entirely of naval orders. When an anticipated order for which the yard had tendered in the early 1990s was awarded by the Ministry of Defence to a different shipyard, the directors asked the bank to appoint receivers.

The receivers arrived to find a business (Shipbuilders Ltd.) with highly industry-specific assets and employees with industry-specific human capital. The only contract which the yard had was with the Ministry of Defence for three frigates, which were at various stages of completion. In considering what to do, the receivers took into account that closing the yard would mean the loss of any revenues from the outstanding contracts (including work already done), which

Interviewee 35 thought were worth 'somewhere in the region of two to three hundred million pounds'. Not only would there be this opportunity cost, but Shipbuilders would incur further liabilities if they terminated the contracts. Furthermore, if the contracts were completed, then it might also be possible to find a buyer for the yard as a going concern. Whilst the receivers thought it was unlikely that a buyer would pay significantly more for the firm as a going concern than for the assets on a break-up basis, a going-concern sale would allow the jobs in the area to be saved. The fact that it was necessary to continue trading in order to complete the contracts meant that this decision was entirely congruent with the bank's interests, regardless of whether a sale was ultimately achieved. As regards the employees, it was clearly in their interests for the yard to remain open. It offered a possibility—albeit perhaps slim—that their employment would be guaranteed by finding a buyer, and in the short run it eased their transition even if they did eventually lose their jobs.

As the receivership progressed, the basic picture was one of solid co-operation between receivers and the workforce, with communication mediated via the union representatives. As Interviewee 35 recalled,

'[T]here was a real spirit of camaraderie built up ... the spirit of working with the unions was tremendous. Sometimes we had real public spats, where we were on different sides of the fence and we took completely different views. ... But actually, behind the scenes, we worked ... closely together to try and achieve the goal of a sale of the yard. [I]t just shows what can be done.'

If a going-concern sale was going to be achieved, it would be necessary to take some new orders. As we have explained, TUPE meant that any buyer would inherit the acquired contractual rights of employees against Shipbuilders. Many of the employees had very long service records, and Interviewee 35 recalled that the receivers had estimated the total potential liability—if all 2,500 employees had to be made redundant—to be in the region of £25m.<sup>40</sup> This was composed principally of redundancy entitlements and contractual

payments in lieu of notice. Interviewee 35 thought that the business, without this potential liability, would have been worth around £10m either as a collection of assets (as indeed it was eventually sold), or a perhaps a little more as a going concern. However, it was clear in his mind that the size of the potential employment liabilities dwarfed the value of the business as a going concern.

Of course, the employment liabilities would only crystallise if the employees were made redundant. Hence if new contracts could be found to provide work for the employees for a period of one to two years into the future, that would give a buyer a reasonable breathing space in which to find future business. It was vital that such contract be obtained, because of the long lag-time involved in shipbuilding. Without new business, at least part of the workforce would have to be made redundant even if the buyer had new contracts ready to start as soon as they took over.

The receivers, assisted by the unions, local MPs and other community representatives, made considerable efforts to find a buyer. There were a large number of responses from all around the world.

‘[T]hey came from [all] across the world: we dealt with Malaysians, people from Singapore; we dealt with Dutch—people from all over—we dealt with a company from Taiwan, we dealt with a company from Korea, as well as some of the European yards, and the British yards as well—[there was] business interest from companies in the UK. But [the potential employee claims] became an insurmountable problem.’  
(Interviewee 35)

Interviewees 36 and 37 verified that TUPE had been a ‘significant issue’ in the negotiations. The outcome was that a going-concern sale was not possible. Shipbuilders’ assets were broken up, with the result that many of the employees faced long-term unemployment.

Firm E5 (Clothing Manufacturer Subsidiary Ltd.) processed textiles to make clothing. It employed about 250 people, mainly women, in the North of England, and went into administrative receivership at the end of May 1998. The receiver was appointed with a view to continuing to trade and selling the business as a going concern. Interviewee 35 recalls that they continued to trade until the end of 1998 in order to seek a buyer. The leading contender was the existing management team, which was seeking to do a buy-out. However, the employees' contractual claims against the company would be inherited by a purchaser under TUPE. This proved to be a significant stumbling block to a going-concern sale.

'[The employees] would have had a decent length of service. ... On average they had something like five years' service, [being paid] £250-300 a week. I would say the liability would probably be something in the order of half a million ... possibly a little bit more because that's just redundancy entitlements, there's also pay in lieu of notice to take into account ... making the total half to three quarters of a million, that sort of magnitude.'

The potential liability for these claims by the employees meant that the purchasers were not willing to pay as much as the receivers wanted for the business. Interviewee 35 could not recall the precise figures which the purchaser had offered, and to what extent this had been affected by the potential liabilities which would be transferred. However, he was firmly of the view that it was the prospect of these liabilities which had meant that they were unable to obtain an offer for the business as a going concern which was greater than the value which they could obtain for the assets on a break-up basis. This meant that they were forced to close the business and sell the assets, as the receivers were under a duty to maximise the returns to the Bank and the preferential creditors.

We consider that cases E1 and E5 therefore offer clear evidence for the existence of what we have termed Category (3) situations, that is, those in which the transfer of employment rights under TUPE actually

causes going concern sales which would otherwise succeed, to fail. However, in case studies E2, E3 and E4, TUPE was irrelevant. Case E2 involved a clothing retailer and manufacturer (Garment Group). Within 48-72 hours of the appointment of the administrative receivers, it was decided that the manufacturing business was not viable, and it was closed. Similarly, part or all of the businesses over which receivers were appointed in cases E3 (Hosiery Ltd.) and E4 (Contractors and Outfitters plc) were also closed. These cases therefore fall into category (1), TUPE having no effect as the businesses are economically distressed anyway. Parts of the businesses in cases E2 and E3 were sold as a going concern, unaffected by TUPE issues.<sup>41</sup> These cases therefore fell into category (2): businesses where the surplus of going-concern value over break-up value is greater than any expected employee costs.

### **3.5 Breaches of consultation rights in insolvency proceedings**

In cases E1 to E4, there appear to have been breaches by the receivership team of the consultation requirements as respects redundancies. Parts of the businesses in E2 and E4 were closed almost immediately after the receivers' appointment, being deemed unviable. In these cases, the costs to the creditors of continuing to pay the employees for 90 days, which would rank as a preferential claim, far outweighed the savings which would be achieved by avoiding liability for a protective award, which would rank only as an unsecured claim, and in practice would be paid out of the National Insurance Fund.

In cases E1, E3 and E4, however, some part at least of the business continued to trade for a period, with a view to realising the value of existing contracts and/or finding a going-concern buyer, and employees were subsequently laid off. In each case, where contracts were 'worked through' employees with different skill-sets were required at different stages of the manufacturing process, and when their useful contributions were finished, they were made redundant. Similar reasoning applied in these cases to those where redundancy was immediate following appointment. For the receivers to continue

to employ people for 90 days simply so as to ensure the statutory consultation period was complied with was just not cost-justified. As interviewee 35 put it,

“[T]here is a clear conflict between insolvency legislation and employment legislation. [There was] nothing would we have liked better with those ... workers at the outset than to have continued to employ them, if we’d had the money to pay them. Employment law required us to consult with them for ninety days, and discuss with them ways to avoid redundancy. The ... problem we had was that we didn’t ... have any resources to pay for them because they couldn’t do any work for us that would have earned any money. So we would have been failing in our duties to the creditors of the company to realise assets to repay their claims if we’d kept the employees on whilst they weren’t doing any productive work.”

A further problem which militated against giving employees anything more than almost immediate notice of their redundancy was the officer holders’ perception that employees, once they thought the business was doomed, would withdraw co-operation. Interviewee 39 explained that employees who know that they are working for a business which will close shortly are apt to ‘develop mysterious illnesses’ or simply not to apply very much effort, once they know that they are certain to be made redundant.

In cases E1 and E4, the relevant trade unions were successful in obtaining protective awards against the receivers in right of the breaches of employment law that occurred. However, interviewees 36 and 40, who had acted on behalf of the unions in cases E1 and E4 respectively, were understanding of the position of the receivers. Interviewee 40 in particular was more concerned about the failure of the incumbent managers to consult with employees prior to receivership, at which stage he felt they must have been well aware of the firm’s financial difficulties.

### 3.6 The effects of *Litster* : when is a dismissal ‘in contemplation’ of a transfer?

As noted in section 2.3, however, breaches of consultation rights will not in themselves lead to the failure of going concern sales, unless potential purchasers are concerned that these dismissals may, following *Litster*, be treated as having arisen in contemplation of a transfer. In case E4, factory premises were sold to a purchaser who then re-employed some of the original staff, which raised an issue as to whether or not TUPE might apply to the sale. The receiver in that case, interviewee 39, explained that he took the view that dismissals did not occur in *contemplation* of a transfer until negotiations had specifically begun with the purchaser. This had not been disputed by the employees.

Interviewee 38 offered us an even narrower interpretation, stating that in his view, a dismissal would not be in contemplation of a transfer unless negotiations in respect of a *particular* transfer had reached the stage that the office-holder was not actively involved in negotiations with any other party.<sup>42</sup> He explained that any broader interpretation would lead to every dismissal in a receivership or administration context being viewed as ‘in contemplation of a transfer’, as office-holders who continue to trade do so with the general idea in mind that if they can find a going-concern buyer they will sell, and redundancies are made in order to facilitate that by closing parts of the business which are no longer viable.

However, it was also acknowledged that these interpretations might not be accepted by an employment tribunal or a court, and that the uncertainty meant that purchasers would nevertheless be concerned about the risk that they might be liable for unfair dismissal of some employees. Interviewee 5 expressed the view that this concern led to office-holders ‘erring on the side of caution’ and dismissing ‘as many people as possible’ as soon as they were appointed, so that it would not be possible to argue that they had been ‘in contemplation of a transfer’.



### 3.7 TUPE as a governance lever

Our final case study (E6) concerns a UK Car Manufacturer (Rover) with several plants located mainly in the West Midlands of England.<sup>43</sup> In late 1999, Rover's overseas parent company (BMW) decided to sell Rover on the grounds that it was running losses of over £2 million per day. Despite this, Rover was not threatened with insolvency. Nevertheless, the break-up of the business was in prospect. If no buyer was found, BMW had plans to liquidate Rover on the basis of a members' voluntary winding-up, making it possible to realise the company's assets and (it was thought) pay off the creditors in full.<sup>44</sup> This would have meant the loss of an estimated 24,000 jobs, not only in Rover's Longbridge plant (which employed 8,000 workers) but also through knock-on effects upon suppliers and dealers and in the wider West Midlands economy.<sup>45</sup>

The break-up option, while leaving shareholders and creditors comparatively unscathed, would have inflicted substantial losses upon other stakeholder groups, in particular employees, long-term customers and suppliers, and the local community. The best outcome for these other stakeholders was clearly the emergence of a buyer who would carry on the business as a going concern while preserving as many jobs as possible. It is in this situation that the role of TUPE in preserving employment rights was once more called into question; TUPE presented a possible obstacle to the sale of Rover to Alchemy Partners, London-based venture capital firm.

Negotiations for the sale of Rover to Alchemy Partners began in secret in October 1999, and were only made public in March 2000 when BMW announced its intention to sell the Rover and MG brands to Alchemy together with the Longbridge plant. BMW indicated its intention to retain the Cowley plant for the production of the new Mini model, and shortly after announced that it would be selling the profitable Land Rover division to Ford. It soon became clear that Alchemy intended significantly to reduce the scale of production at

Longbridge, by focusing on the small niche market for MG cars at the expense of the Rover brands. On this basis, its bid received a hostile reception from the trade unions and a frosty one from local authorities in the West Midlands. In late March a rival bid, which became the Phoenix consortium, was announced. This was led in due course by John Towers, a former chief executive of Rover, and was premised on retaining Longbridge as volume car production facility. However, for most of the month of April, BMW refused to enter into negotiations with Phoenix, and continued instead to move towards finalising the sale of Rover to Alchemy.

When the sale to Alchemy was pending, six new business units were formed as subsidiary companies of the Rover Group. The shares in these companies were then purchased by BMW's UK holding company. The purpose was to separate out those parts of the group which would stay with BMW (such as the engine plant and the Cowley works which was to be retained to produce the new Mini model for BMW), those which would be sold to Ford (Land Rover), and those parts which would be left for Alchemy. The effect was to create seven subsidiaries in all, including the original Rover Group company from which the other six had been spun off. The intention was to effect the sale of the Longbridge assets to Alchemy in the form of a transfer of shares in the residual Rover Group company.<sup>46</sup>

Since the sale of Rover would only involve a transfer of shares and not a formal change of employer, it could have been argued that TUPE did not apply to the sale. If this was the case employees would have retained whatever statutory and contractual rights they had when Alchemy took over, but there would no duty to consult or inform in respect of the takeover. Nor would Alchemy have been rigidly bound to preserve terms and conditions after the transfer.

However, it was also arguable that transfers had taken place in the case of the creation of the six new subsidiary companies, to which employees within the relevant business units had been allocated. This was because it was akin to a process of hiving down of the type

which, under case law, could be regarded as a single transaction, in which BMW's UK holding company was substituted for Rover as the employer. The unwillingness of the courts to accept that TUPE could be avoided by complex transactions of this type was reasserted in the recent decision of the High Court *In the Matter of Maxwell Fleet and Facilities Management Ltd.*<sup>47</sup> Lawyers acting for a group of managerial employees advanced the argument that the creation of the 'residual' Rover company, in anticipation of the sale of shares to Alchemy, was also akin to a hiving down and, as such, would in due course be caught by TUPE. This point was less clearly in the employees' favour, but it could not be said to have been beyond doubt.

Neither Rover Group nor any of BMW's other UK subsidiaries had entered into consultation with employee representatives over the transfers. The relevant employee representatives were the recognised unions, which thereby had the opportunity to initiate litigation directly. It was also argued by the employees that since both BMW and Alchemy had indicated that there would be redundancies arising from the sale of Rover Group and the other subsidiary companies, a breach of the redundancy consultation laws had occurred. Liability under any protective award made against BMW or its subsidiaries for failure to comply with the information and consultation requirements would have been transmitted to buyers of its businesses. On these various bases, the unions lodged applications for protective awards covering all 28,000 employees of the former Rover Group before employment tribunals at the end of April 2000. In addition, steps were taken to prepare individual claims in respect of breach of contract for dismissals carried out in contravention of 'no compulsory redundancy' agreements entered into between Rover and the unions, which, it was claimed, had been incorporated into employees' contracts of employment. Altogether, the potential value of these claims exceeded £300 million.

It was against this background that Alchemy withdrew from negotiations with BMW on 27 April, only a day or so from the

deadline set for finalising the deal. The catalyst for this turn of events was BMW's insistence that Alchemy should offer it an indemnity against potential claims for (among other things) breach of the information and consultation laws, and contractual claims for wrongful dismissal. It was reported that Alchemy had been ready to pay £50 million for the company, with BMW meeting certain liabilities arising from restructuring, but that it was not prepared to agree to an indemnity extending to 'hundred and hundreds of millions of pounds.'<sup>48</sup>

The sale to the Phoenix consortium was completed on 10 May. Rover was sold for a nominal £10, with BMW putting in £575 million to help meet short-term running costs. The Phoenix management pressed the unions to agree to a waiver of claims arising out of the failure of BMW (through Rover) to begin consultation at the time the prospective sale to Alchemy was announced. Although the claim was not waived, agreement was reached on its withdrawal on the basis that consultation between Phoenix and the unions had begun at an earlier date. The effect was to save £100 million. In return, Phoenix agreed to insert enhanced redundancy terms in the contracts of employment of Longbridge employees. A further £200 million was saved by Phoenix's decision to dismiss fewer than 1,000 workers at Longbridge, thereby avoiding large-scale redundancy compensation claims.

Lawyers acting for the unions involved commented at the time: '[i]t was the unions' intention to put as many [legal] obstacles in Alchemy's way as possible, but at the same time not to roll over... and give a blank cheque to John Towers [head of the Phoenix consortium]'.<sup>49</sup> According to lawyers acting for the Rover managers, 'the same employment issues that bedevilled the Alchemy bid arose again but were resolved by discussion, negotiation and agreement'.<sup>50</sup> Without formally waiving their claims, the employees and their representatives had found themselves in a position where their involvement in the rescue process had led to the success of the one bid which was consistent with maintaining Rover as a volume car

producer. To what extent does this confirm the hypothesis that employment laws have a role to play in strengthening stakeholder voice during the rescue process?

As one of the unions' lawyers said, '[w]e threw a lot of things in the air in the hope [the bid] could go wrong for Alchemy'.<sup>51</sup> The issue, for example, of whether a TUPE transfer would have occurred when Alchemy purchased the shares in the residual Rover company was never tested; it was unclear how far, if at all, the corporate veil could be lifted to attach various liabilities incurred by BMW's subsidiaries on to its UK holding company; and the issue of the contractual status of the original no-compulsory-redundancy clauses remained unsettled. It was possible that had these issues come to court, they would have been resolved in favour of the employer. However, during complex and difficult negotiations, these legal issues posed enormous potential risks for any buyer of Rover which intended to carry out large-scale restructurings. Phoenix's advantage, in this respect, was the limited degree of restructuring which it intended to carry out.

There are aspects of the Rover case which could have made it a one-off. The unions' strategy of launching litigation in order to discourage an unwelcome bidder might have misfired badly if no other bidder had emerged, and the company had finally failed. There was a perception that Rover would not, ultimately, be broken up, partly because of the bad publicity which this would have engendered for BMW, and also because of the adverse political ramifications of such a development. This may have lent more credibility to the unions' threats than would otherwise have been possible. On the other hand, there was no guarantee that the company would not fail, and its demise was widely predicted at several stages of the negotiations. The Rover case is therefore evidence that factoring employee interests into the restructuring process can result in outcomes which both protect the firm specific human capital of the workforce without undermining the preservation of jobs. Indeed, the role of the law in Rover case was more positive than that - by requiring a potential purchaser to bear the costs of large-scale redundancies, it served to penalise a bid which

would have broken up the company, leaving the Longbridge plant a shadow of its former self, and favoured an alternative which minimised the extent of job loss.

#### 4. Conclusions

It is increasingly recognised that a high proportion of the value of companies lies in the skills and commitment of employees, and that the importance of this firm-specific human capital is likely to grow in future as a result of the direction of technological and organisational change (Blair and Kochan, 2000). It is something of a paradox, then, that corporate governance arrangements do not seem to be evolving in such a way as to provide mechanisms for the recognition and protection of employee interests. On the contrary, it seems that the primacy of a 'shareholder value' norm is widely accepted among policy-makers, scholars and corporate governance practitioners, particularly (but by no means exclusively) in the United States and Britain. A major obstacle to employee governance is, it seems, the unfeasibility of granting employees property rights in the firm which might compete with and possibly undermine the residual claims of shareholders. The downside of stakeholder representation is the prospect of deadlock in corporate decision making.

In this paper we have developed the concept of employees' *contingent control rights* in a way which can not only throw light on existing aspects of the law relating to the position of employees in the firm, but to suggest one way out of the impasse on corporate governance just referred to. We saw that aspects of employment law in Britain (and even more so in other EU systems) do provide employees with a set of claims on the enterprise which reflect their firm-specific investments. These claims are contingent in the sense that they are only triggered when the firm-specific interests of employees are threatened by a restructuring, as in the case of large-scale redundancies, transfers of business, outsourcing and, to a lesser degree, a takeover bid. They have a property-like aspect to them since they run with the assets of the firm in such a way as to bind third

party purchasers and others who may assume control of the undertaking of part of it in the course of a restructuring. This property-like effect is brought about by various mechanisms of which the novation of contractual and statutory rights contained in TUPE (and, elsewhere in the EU, by other local implementations of the Acquired Rights Directive) is the most important in practice. The rights can be described as rights to control since, while not allowing employees a veto over organisational changes proposed by management, they nevertheless factor employee voice into the restructuring process in such a way as to internalise certain of the costs of restructuring which would otherwise fall on those with firm-specific human capital at risk. This is done through a combination of individual employee claims to compensation and/or continuing employment in the event of restructuring, and the triggering of information and consultation rights for employee representatives.

The economic consequences of laws granting employees contingent control rights are potentially far reaching. By protecting investments in firm-specific human capital, they enhance *ex ante* incentives for mutual commitments for long-term Cupertino between labour and management. But at the same time they raise the unwelcome prospect of co-ordination failures brought about by inter-stakeholder conflicts. In the context of insolvency, the clash between employee interests and creditor interests threatens to undermine well-established mechanisms for minimising the collective action costs of creditor decision-making. The further effect of this may be to make corporate failure more likely in situations where the survival of the firm is finely balanced.

Our empirical, case-study based research suggests that both these effects are possible. The case of Rover illustrates the role played by the law in tilting the bargaining process in favour of an outcome which both preserved employment and safeguarded the employees' interests in the maintenance of the enterprise over the long term. Employment law brought about a situation in which some of the costs of restructuring to the employees would have fallen on a potential purchaser, whose break-up plan, as a result, seems to have become

impractical. Without TUPE, then, it is most likely that Rover would have been broken up and the possibility lost of retaining the UK's last indigenous volume car producer. Only time will tell whether this particular experiment in partnership will succeed; for present purposes, the point is that without the opportunity which the law gave to the employee representatives to enter the bargaining process, the experiment would not have taken place. Yet in other case studies, the negative side of TUPE is clear. There will undoubtedly be cases in which the prospect of employee liabilities being transferred to a potential purchaser will tip the scales against a successful reorganisation. Here, the law appears to work in a way which, as critics have suggested, is essentially self-defeating.

To make progress on the question of how to regard TUPE, we need to return to the concept of contingent control rights. The aim of these rights is two-fold: to protect firm-specific interests when they are at risk; and to provide a mechanism for resolving the high collective action costs of internal governance. From this perspective, attention should focus on the effectiveness of the mechanisms contained in TUPE for dealing with divergences of interest within and between the different stakeholder groups involved in a restructuring. On the positive side, TUPE provides a basis on which a designated representative of the employees - either the recognised trade union or unions in the enterprise concerned, or the default representatives provided for by statute - has the power to enter into negotiations with the employer over the terms on which the restructuring will take place. On the negative side, however, the capacity of the employee representatives to deliver an effective compromise to the employer which will bind the employees is far from clear. Uncertainty surrounds the basis on which employment rights subject to TUPE can be waived, and whether the employee representatives should have the power to engage in bargaining which will inevitably mean compromising the claims of some workers in order to protect the interests of others.



Article 4a of the Acquired Rights Directive, which was introduced in 1998 as part of a wider attempt at liberalisation of the Directive's provisions, marks a significant step in the direction of permitting this kind of bargaining. It permits a Member State to make provision for a partial derogation from the protective ambit of the Directive, according to which:

'the transferee, transferor, or person or persons exercising the transferor's functions, on the one hand, and the representative of the employees, on the other hand may agree alterations, in so far as the current law or practice permits, to the employees' terms and conditions of employment designed to safeguard employment opportunities by ensuring the survival of the undertaking, business or part of the undertaking or business'.<sup>52</sup>

This may only be done during 'insolvency proceedings which have been opened in relation to a transferor (whether or not those proceedings have been instituted with a view to the liquidation of the assets of the transferor) and provided that such proceedings are under the supervision of a competent public authority (which may be an insolvency practitioner determined by national law)'.<sup>53</sup> In addition, a Member State may take advantage of the derogation in the case of 'any transfers where the transferor is in a situation of serious economic crisis, as defined by national law, provided that the situation is declared by a competent national authority and open to judicial supervision, on condition that such provisions already exist in national law by 17 July 1998'.<sup>54</sup> The potential incorporation of these provisions into UK law raises many difficult issues which have been discussed elsewhere (Davies, 1999; Frisby, 2000). We wish to focus here on the assumption behind the derogation, namely that employee representatives are in a position to enter into what is, in effect, concession bargaining over transfer rights in an effort to preserve jobs.

The Rover case suggests that bargaining over the application of labour standards can be a means of achieving flexibility within the operation

of the law, while still maintaining a role for employment rights in channelling the bargaining process in favour of an inclusive, stakeholder-orientated outcome. However, it should be borne in mind that the negotiations which went on during the Rover negotiations did not require the kind of formal derogation contained in Article 4a of the Directive.

Nor did the unions see themselves as engaged in concessions, despite press reports referring to 'waiver' of rights. In the final outcome, the law favoured Phoenix in large part because its programme of restructuring involved far fewer job losses. The dangers for unions of engaging in open concession bargaining are considerable, in particular at a time when one of their principal roles has become the monitoring and enforcement of rights which are provided by legislation (Brown, Deakin, Nash and Oxenbridge, 2000). The difficulties facing any system of derogation through collective bargaining are intensified further in non-union workplaces where the conditions for collective representation of employee interests tend to be lacking. If employee governance is to become a reality in the context of restructuring, it may be necessary to consider ways in which the institutions of independent employee representation can be strengthened.

## Notes

1. Furthermore, in the period leading up to default, shareholders experience perverse incentives giving rise to 'financial agency costs'.
2. 11 USC § 362.
3. IA 1986 ss 128, 130(2), 183, 184.
4. *ibid* ss 10, 11.
5. Note that the distinction between 'personal' and 'proprietary' claims drawn here is different to that drawn by Calabresi and Melamed (1972) between 'property' and 'liability' rules. The latter distinction refers to the type of protection afforded to a legal entitlement; the former relates to the scope of the potential parties against whom the entitlement will be protected.
6. Employment Rights Act 1996, Part XI; Deakin and Morris, 2001: ch. 5.6.
7. Employment Rights Act 1996, Part X; Deakin and Morris, 2001: ch. 5.5.-5.6.
8. For the law on redundancy consultation, see Trade Union and Labour Relations (Consolidation) Act 1992, ss. 188 et seq.; for the law on consultation in relation to transfers, see TUPE 1981, regs. 10-11A. For an account of the law, see Deakin and Morris, 2001: ch. 9.3.
9. See City Code on Takeovers and Mergers, rule 24.1, discussed by Deakin and Slinger, 1997.
10. *Wilson v. St. Helens BC/Baxendale v. British Fuels* [1998] IRLR 706; Deakin and Morris, 2001: ch 3.9.3.

11. [1998] IRLR 706.
12. The relevant case law, and the reasons for this divergence, are discussed by Deakin and Morris, 2001: ch. 5.6.5.
13. See Deakin and Morris, 2001: ch. 3.9.2, for a review of the relevant case law of the UK courts and of the ECJ.
14. [1998] IRLR 706.
15. On 'hiving down', see Deakin and Morris, 2001: ch. 5.6.5, and for an important High Court decision restricting the scope for arrangements of this kind to escape TUPE, see *In the matter of Maxwell Fleet and Facilities Management Ltd.* [2000] IRLR 368.
16. The relevant law for present purposes is contained in Trade Union and Labour Relations (Consolidation) Act 1992, ss. 188-188A, and in TUPE 1981, regs. 10-11A. See Deakin and Morris, 2001: ch. 9.3.1, for a general account of the relevant law on the representational capacity of recognised trade unions and other specified employee representatives.
17. Directive 77/187, Art. 3(3) (in the original Directive, prior to the amendments made by Directive 98/50, this was Art. 3(2)).
18. Insolvency Act 1986 ss 175, 386; see also *ibid* Sch 6 paras 9-12; Insolvency Proceedings (Monetary Limits) Order 1986 (SI 1986/1996), art. 4.
19. Insolvency Act 1986 s 40.
20. Broadly defined to mean in this context administration, liquidation, receivership or the approval of a company voluntary arrangement: Employment Rights Act 1996 s 183(3).

21. Employment Rights Act 1996, ss 182, 184.
22. *Ibid.* s 186.
23. *Ibid.* s 189, as amended.
24. Insolvency Act 1986, ss 19, 44; *Powdrill v Watson* [1995] 2 AC 394.
25. In the case of administration, such sums are charged on the assets of the company and payable in priority to any claims secured by floating charges and the administrator's own remuneration (*ibid* s 19). In administrative receivership, the receiver is personally liable for such sums, but is in turn entitled to a statutory indemnity out of the assets of the company for such liability, payable in priority to the claims of his appointing debenture-holder (*ibid* ss 44(1), 45(3)). *Cf* the position where a non-administrative receiver is appointed, where such liability is not limited to claims arising during the period of the receivership (*ibid* s 37).
26. See, in relation to administrative receivers, *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949; *Downsview Nominees v First City Corporation Ltd* [1993] AC 295; *Medforth v Blake* [2000] Ch 86 (receiver owes duty of loyalty to appointing debenture holder and timing of sale is to be set in accordance with the latter's interests; however receiver also owes duty of care to the company at the time of sale to ensure that best price reasonably obtainable at that time is realised) and, in relation to administrators, *Re Charnley Davies (No.2)* [1990] BCLC 760 (administrator owes duty to company to take reasonable care to obtain best price for assets on basis of such information as reasonably available to him at the time).

27. If  $v_b$  represents the bad state, which occurs with probability  $p$  (where  $0 < p < 1$ ) and  $v_g$  represents that good state, which occurs with probability  $(1 - p)$ , then  $\bar{v} = pv_b + (1 - p)v_g$ .
28. See section 2.3, above.
29. Under Trade Union and Labour Relations (Consolidation) Act 1992, s. 188, the period over which consultation must take place is 90 days before the first dismissal takes effect if the employer proposes to dismiss 100 or more employees at one establishment, and 30 days before the first dismissal takes effect if it is proposed to dismiss between 20 and 99 employees at one establishment. The meaning of the term 'establishment' and the issue of the timing of redundancy notices with regard to the consultation requirement are discussed by Deakin and Morris, 2001: ch. 9.3.1. Under certain limited 'special circumstances', an employer is absolved from a failure to consult, but this category does not extend to all insolvency situations, merely those which involve a high degree of suddenness of unexpectedness. Even then, it is not clear that the 'special circumstances' defence is compatible with the Collective Redundancies Directive: see Deakin and Morris, *ibid.*
30. See above, text to nn 21-23.
31. [1989] IRLR 161; see above, section 2.3.
32. See above, section 2.3.
33. The majority of interviews were recorded and transcribed. Where they were not recorded, detailed notes were taken during the interview.
34. Many of the interviewees wished us to maintain confidentiality both with respect to their identities and the details of the firms forming case studies. Where appropriate, case histories were

sent back to interviewees for clearance prior to publication. With the exception of the well-known Rover case (see below, section 3.7), we have not referred to firms by name in this paper.

35. Interviewees 1-10 and 12.
36. Interviewees 1, 2, 4, 5, 8 and 9. Interviewee 11 made a similar point, although he himself tended to advise mainly on liquidations rather than administrations or receiverships.
37. Interviewees 1, 4, 5 and 8 made very similar observations. Interviewee 9, however, seemed perhaps less concerned, stating that, "it's something that's there and it's something that people have to live with."
38. Interviewees 35, 38 and 39.
39. Interviewees 2, 5, 35, 38 and 39.
40. This should be couched with the caveat that he was far from sure that this was in fact the correct figure, it being several years since the events took place.
41. In case E2, the employees of the retailing business were, as is standard in that sector, on short-term contracts and hence redundancy entitlements were minimal. In case E3, TUPE had led to some discounting of the purchase price, but the receiver (interviewee 38) could not remember by how much.
42. This need not, however, amount to the grant of a 'lock-out': the office-holder would still be bound to accept a higher offer should a third party make one, but simply would not be actively involve in negotiations with any other parties.
43. This section draws substantially on Armour and Deakin (2000).

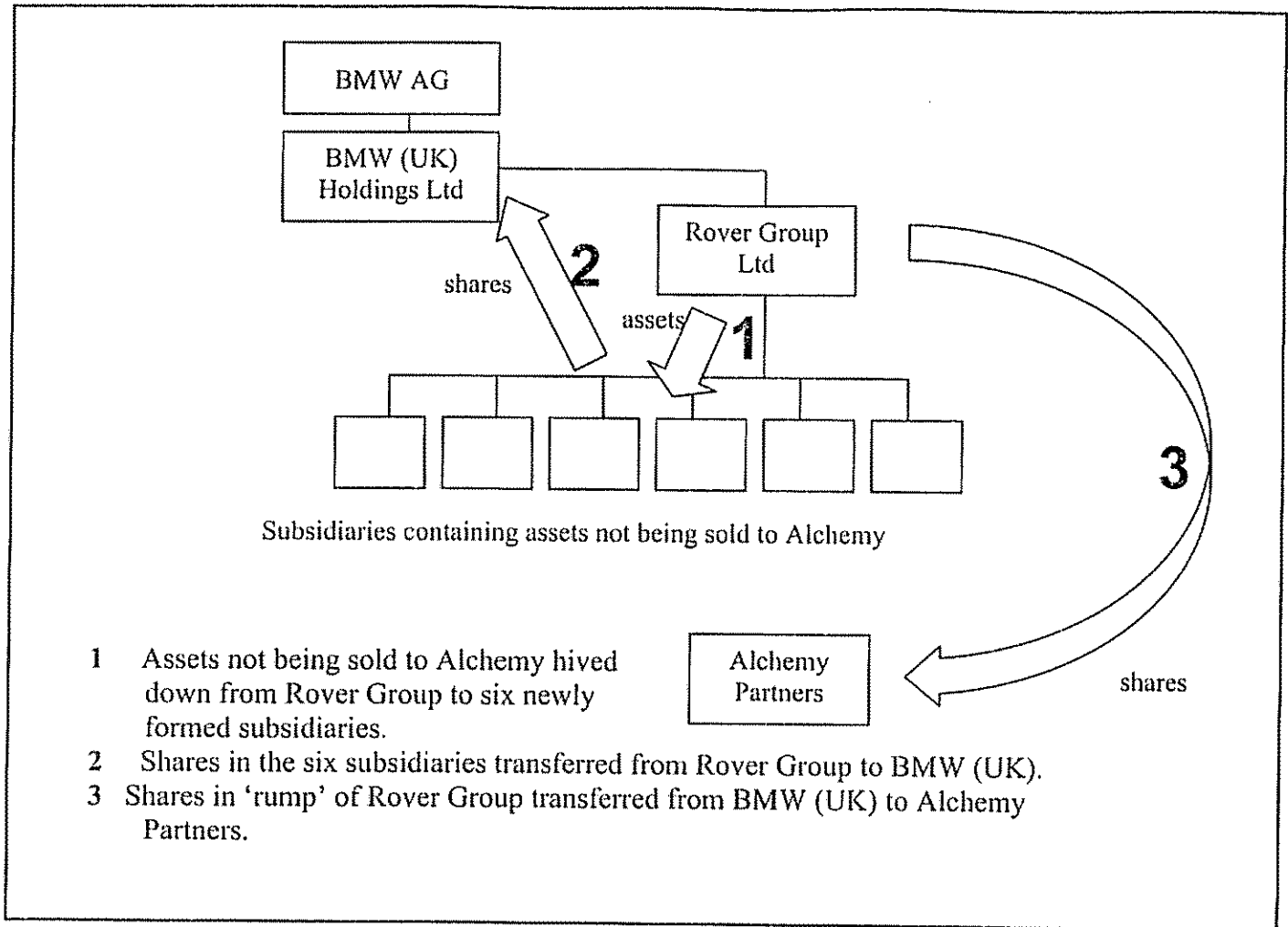
44. *Financial Times*, 'BMW may consider liquidation of Rover Cars', 1 May 2000.
45. See, e.g., *The Guardian*, 'He liked Rover so much he bought it. For £10', 10 May 2000.
46. See diagram 1.
47. [2000] IRLR 368, 372-373.
48. *Financial Times*, 'How the Alchemy deal fell apart', 1 May 2000.
49. *Financial Times*, 'Claims that hurt Alchemy bid to be waived', 9 May 2000.
50. *Ibid.*
51. *Ibid.*
52. Directive 77/187, Art. 4a(2)(b), as amended by Directive 98/50.
53. *Ibid.*, Art. 4a(1).
54. *Ibid.*, Art. 4(a)(3).



## **TABLE AND DIAGRAM**

Case Study	Synopsis	Interviews
E1	<p>Shipbuilder located in North East England.</p> <p>c. 2,500 employees with significant firm-specific human capital, plus 'several times' this figure employed in local businesses dependent on the firm for survival.</p> <p>Administrative receivership May 1993.</p> <p>Contracts 'worked through' for 18 months, then closure and break-up sale.</p>	<p>(35) Member of receivership team</p> <p>(36) Union chief negotiator</p> <p>(37) Local MP</p>
E2	<p>Specialist clothing manufacturer and retailer. Factories and retail outlets located across UK.</p> <p>c. 1,300 employees, split between manufacturing and retail arms.</p> <p>Administrative receivership May- June 1998.</p> <p>Manufacturing business closed almost immediately, then break-up sale. Retail business sold as going concern.</p>	(38) Administrative receiver
E3	<p>Textile manufacturing group (hosiery and knitwear) based in East Midlands.</p> <p>c. 1,100 employees.</p> <p>Administrative receivership May- June 1998.</p> <p>Knitwear division contracts 'worked through' then closure and break-up sale. Hosiery division sold as going concern.</p>	(38) Administrative receiver
E4	<p>Contractors and Shopfitters, located in Northern England.</p> <p>c. 180 employees.</p> <p>Administrative receivership June 1998.</p> <p>Contracting business closed almost immediately, then break-up sale. Shopfitting business contracts 'worked through'; closure and break-up sale.</p>	<p>(39) Administrative receiver</p> <p>(40) Area union representative</p>
E5	<p>Clothing Manufacturer, located in North East England.</p> <p>c. 250 employees.</p> <p>Administrative receivership May 1998.</p> <p>Business continued to trade until end of 1998, then closure and break-up sale.</p>	(35) Member of receivership team
E6	<p>Car Manufacturer, located in West Midlands.</p> <p>c. 8,000 employees with significant firm-specific human capital, plus c. 16-19,000 employed in local businesses dependent on the firm for survival.</p> <p>Restructuring and going-concern sale of business May 2000.</p>	<p>(46, 47) Lawyers acting for managers</p> <p>(48) Lawyer acting for employees</p>

**Diagram 1: Structure of the proposed sale transaction**



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