

## Due Diligence In The UK – Some Key Labor Issues

By Michael Sippitt

CLARKSLEGAL LLP

Corporate and financial considerations can dominate the process of acquiring a business, and there are usually time pressures which mean enquiries are not as thorough as they should be. Whether the business is acquiring shares, assets, goodwill, or winning or taking over a contract, detailed labor due diligence should not be overlooked as the value of a deal can be severely reduced by unforeseen labor-related liabilities.

The classic way to go about “due diligence” in the UK is for the acquiring company to present the target with a long list of questions about all aspects of the business the acquirer wants information on before committing to the deal. Emphasis on labor issues may not be adequate to cover the ground. Information needed will depend on the nature and size of the business, but usually falls into the following broad categories:

- Who are the employees/workers the company will be inheriting? What do they do, what pay and benefits do they receive and what are their contract terms? You should be clear on these issues before committing to the deal because the Transfer of Undertakings Regulations (TUPE) severely limit an employer’s ability to rid the business of unwanted or expensive

employees following an acquisition. If you want to make such changes you should discuss them with a UK labor lawyer at the earliest opportunity.

- Collective employment relations arrangements and history. This covers the structures in place for collective bargaining or giving information to and consulting employees.

- Has the current employer been complying with all legal requirements for their staff? Not all transgressions will attract sanctions, but they may be an indicator of poor standards of compliance which in themselves might merit further investigation. Levels of past disputes and claims are also a strong indicator of employment relations in the target business.

- Information about potential labor challenges and known liabilities, such as outstanding disciplinaries and grievances, tribunal claims and absent employees.

All businesses operating in the UK will soon have to factor in compliance with age discrimination legislation, which comes into force in the UK in October 2006. Although draft legislation was published in July, giving employers more than a year to prepare for the new rules, they are complex and will be difficult to implement for many businesses. Not least because they protect workers of all ages from age discriminatory practices, and so promise to be one of the most fundamental changes to effect workforce planning in the UK for many years. Making checks now on a target’s recruitment, reward and retirement practices will help avoid costly surprises next year, as damages awards will be uncapped.

Due diligence is not always straightforward where the business inherits staff by taking over a contract from a current contract provider. Often how much due diligence can be done will be determined by the level of information available from the existing contractor. It may not even be clear that *any* staff will be inherited. That will depend on whether TUPE applies to the transaction. The UK is expecting new TUPE Regulations to come into force in April 2006. Then the position should be clearer as most changes of contractor will be covered by the new regulations.

The data collected needs to be assessed to work out if further questions should be asked, and to determine the extent of any potential liabilities. It is important to never lose sight of the commercial realities of the deal. For example, it may not matter if the directors do not have service agreements if they will be entering into new contracts as part of the deal. However, complex discrimination claims, or circumstances that would give rise to them, are more serious as they can be expensive to defend and can also have an impact on a business’ reputation.

Here are some other issues that are sometimes overlooked during a due diligence process:

- Rights transferring under occupational pension schemes. The European Court of Justice’s decision in *Beckman* established that benefits under occupational pension schemes which do not relate to old age or retirement do pass on a TUPE transfer. These could take the form of enhanced payments on redundancy or early retirement pensions –

---

*Michael Sippitt is Managing Partner and Penny Hunt is Senior Solicitor with Clarkslegal LLP, London. Visit the website of Clarkslegal LLP at [www.clarkslegal.com](http://www.clarkslegal.com). Clarkslegal LLP is also a member of TAGLaw, a worldwide legal network of independent law firms. The TAGLaw network has 134 firms in 80 countries and 120 jurisdictions.*

**For further information, please contact Michael Sippitt at [msippitt@clarkslegal.com](mailto:msippitt@clarkslegal.com) or Penny Hunt at [phunt@clarkslegal.com](mailto:phunt@clarkslegal.com).**

either can be prohibitively expensive. Details of these benefits can usually be found in the pension scheme documentation. Quite separately, the Pensions Act 2004 gave occupational pension scheme members rights to pension benefits after TUPE transfers for the first time, so this cost will also have to be accounted for.

- **Employment status:** Staff may be described as “consultants” or “self-employed” but the law on employment status is complex and there are essentially three possible categories staff could fall into:

- a) Employees (permanent or temporary)
- b) Workers (not full employees but protected by some statutory rights)
- c) Self-employed (not protected by employment rights but still may have some protection, e.g. against discrimination).

- **Employment relations:** It is very important to find out all you can about the employment relations environment at the target company. What collective consultation mechanisms are there? Is a union recognised? Has there been any bid for union recognition, or is one threatened? Has there been any industrial action recently? A new owner does not want to find it has imported a disrupted workplace environment into its otherwise stable business, or that it does not have the control over wage costs it had hoped for.

- **Equal Pay:** Campaigning by unions to use equal pay, (in effect sex based pay discrimination), to force up wage rates has been significant in the public sector, but businesses in the private sector are exposed too, especially if they are acquiring employees who have been outsourced from the public sector. Due diligence should include an analysis of equal pay risks, and what it may mean for the cost assumptions the deal is based on. It is one of the biggest issues facing some UK businesses as equal pay claims can threaten wage structures. Increasingly, legal time is being spent on such claims.

- **Processes:** It is better to find out at an early stage how good the target's internal processes are, in order to make an assessment of the reliability of information. Does the business really have a good grasp of its own workforce issues and risks?

- **Quality of contracts:** It can be very hard to change employment contracts, as this may give rise to tribunal claims for

unfair dismissal. Clarify the scope for flexibility, and identify the extent of post termination restrictions and how reward structures operate.

For acquisitions that take place from April 2006, the new draft TUPE Regulations affirm a right for employees to claim constructive dismissal if there is a substantial change to working conditions to their detriment following a TUPE transfer. This will give employees greater scope to sue their employer as current case law generally restricts this right to cases where there is a change in *actual* terms and conditions of employment only. Assuming that the new Regulations are implemented in their current form, which is by no means certain, businesses will have to consider whether there could be a detrimental change to working conditions after the transfer.

Problems identified during a due diligence process can often be dealt with by minimising risk through taking indemnities or getting a reduction in the deal price. If the business is aware of labor issues that carry hidden costs, it can weigh them up in the context of the commercial realities of the deal and may be able to cover the risk. If labor liabilities only surface after the deal is done they may seriously challenge the profitability of the new business, or in extreme cases threaten its very existence.

What is clear is that a thorough labor due diligence process is a very important aspect of preparation for a business purchase or bidding to take over a contract, but more can also be done to ensure a smooth transfer of a business. Knowing the ownership of your employer is about to change can be very worrying for employees. Whilst TUPE protects their pay and benefits, many fret about the impact on the culture of the organisation and how they will fit in. Following an acquisition, senior management often change and executives may feel vulnerable. Some employees will choose to leave rather than deal with workplace change. Employee communications, coupled with expert human resources assistance, are key at these times for managing expectations and dealing with questions. There may be a need for expert recruitment assistance at short notice if key players decide not to make the transition or are not wanted.

It is no longer true that only large, listed companies need to pay attention to how they are perceived in the media.

Often, previously unheard of businesses find themselves the focus of unwanted attention, and are ill-prepared to deal with media relations. First impressions are frequently what most people remember about a news story, so it is important to tell your side of the story, and tell it quickly. Therefore the labor due diligence may be supplemented by some helpful analysis of how the acquisition may be presented in local, trade or even national media and what should be done to control this process. A labor related dispute may quickly change the credibility of the business and its customer base.

Spend time working through the flexibilities that are possible with the business given the relative flexibility of the UK labor market. Due diligence should not just focus on how bad (or good) things are, but on getting a clear view of how they could be improved. In the average corporate deal it is inadequate to know what the situation is today without some helpful analysis of what could be done for the business in the future. There are several options as to how the workforce can be organised. Particular features to consider in addressing how much can be done include the suitability of fixed-term employment contracts and the use of temporary agency labor. There may also be the potential for cost savings through improved work practices, thereby making risky contractual changes unnecessary.

Once due diligence enquiries are complete, it is critical that the new owner has a clear perspective on how the change management process will be implemented, and identifies and addresses early on the issues that require change. Issues need to be handled sensitively and in a way which avoids disruption. For example, if a significant change process is envisaged or employment relations with the union are fragile, it would be foolish not to address the need for contingency planning to protect the business against serious disruption as soon as changes are implemented or threatened.

Last but not least, in any labor planning in the UK and the EU, the preparation will often include arrangements for informing and consulting staff on changes or job reductions, so the data gathered at due diligence stage must support the effective management of this process both for smooth transition and for legal compliance.