editorial

KELLY PARSONS *editor*

Ensuring a positive return

Europe's private equity market has come a long way since we examined this burgeoning practice area three years ago. Back then partners were dubious about whether its growth was sustainable and reluctant to hire extra staff in case the progress was short-lived.

Yet by all accounts this was a huge underestimation. Private equity has now surpassed even the heady heights it reached during the dotcom boom. And, as our cover story this month reveals, it has moved from the shadowy fringe to become a mainstream asset class in its own right.

Across Europe our readers and contributors report that private equity is an increasingly important revenue source for both large and small law firms. And, as competition in the sector grows, and they gear up for what looks to be yet another bumper year, the knock-on effect is obvious: rivalry for experienced lawyers has led to some high-profile poaching – with Lovells being one of the worst hit.

The tantalising prospect of Europe's first €20 billion deal may ensure that the appetite of the region's lawyers for private equity remains strong, but the present 'king of capital's' reign is nonetheless tainted with an air of negativity. Private equity's success has been accompanied by a whole gamut of difficulties. Criticism persists – mainly originating from the public company sector – that the tax-driven highly-leveraged style of financing utilised by private equity houses is not only irresponsible but is also less than transparent. If pressure continues and regulators decide that private equity's current freedoms should be curbed, a stifling of the market will be inevitable.

Another concern is that private equity is in danger of losing its creativity. As suitable targets become scarce and secondary buyouts, which merely 'pass the parcel' of profits from one entity to another, are commonplace, it is increasingly difficult for investors to add value or generate significant returns. Private equity was initially utilised to develop innovative instruments that released unrealised value, but it has clearly lost some of its opportunism. However, as the example in Hungary outlined in our cover story shows, there is still a place for inventiveness and flexibility – the very essence of the private equity concept.

Creativity of a different kind is under discussion in top law firms as they struggle to stem the flow of dissatisfied associates leaving for smaller practices or to in-house positions. While this trend is far more pronounced in London and within US firms, it is creeping into Europe's mainland and will further deteriorate if ignored.

The price paid for success can also be seen here. Law firms have grown in size and scope, and the number of staff needed to support the business has increased. Consequently, opportunities for younger practitioners to reach the upper ranks have dwindled. As these lawyers vote with their feet, firms are realising that the flip side of maximising profits through high partner to assistant ratios is widespread dissatisfaction and low motivation among those at the losing end of the partnership prospects equation.

Again, the key is innovation and awareness that firms must evolve to accommodate current market conditions. Our feature 'A way through the wilderness' on page 32 analyses the solutions being developed to tackle the attrition issue. More differentiation of seniority is one approach, giving certain associates stronger management positions. A proposal mooted at Allen & Overy would introduce the role 'of counsel' for associates not aspiring to partnership and 'managing associate' for those recognised as on a fast track towards it.

Whether these new categories become the norm in Europe's law firms remains to be seen. While the larger, predominantly Anglo-Saxon players clearly have the most work to do, smaller practices are not immune. Whatever their size, firms which invest the time and vision now to find new ways to keep their future leaders happy and motivated, will be sure to reap the benefits later. ■

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The outsourced workforce: prepare for EU pitfalls

Companies which outsource functions in other member states will find a pan-European approach hampered by countries' individual approaches to implementing directives. GERNOD MEINEL, THIERRY MEILLAT and ANNETTE PARTRIDGE outline some of the national labour law distinctions

Sophisticated businesses are always considering ways to become more effective and outsourcing non-core operations is a key strategy for achieving this. Increasingly, companies are looking internationally for support and more cost-effective solutions. Therefore, given the significance of the workforce in many outsourcing projects, it is essential to investigate and understand local labour laws and to plan to cover their impact.

The Acquired Rights Directive (77/187/EEC) aims to provide protection for employees in the event of a change of employer and can have a significant effect on outsourcing activities. Unfortunately, the existence of the directive does not mean the law operates uniformly throughout the EU, as the method by which various provisions operate is left to each member state to decide. This often leads to complications when dealing with multi-jurisdictional transactions, since when countries integrate directives into their local legislation, they apply procedures and remedies with which they are familiar so businesses cannot adopt a pan-European approach.

Before examining in detail the specific nuances which can cause problems in multi-jurisdictional outsourcing transactions, it is important to be reminded of the key principles of the directive: employees and their representatives must be consulted before the transfer of the operation takes place; employment contracts are conveyed from the original employer to the new operator automatically; employees' existing legal entitlements are protected and they must be retained on the same terms; and workers are protected against dismissals.

Any outsourcing agreement has to consider each country separately and accommodate the local variations. For example, consultation obligations which are familiar to continental Europeans such as the French and Germans are emphasised under their legislation. However, they play a smaller part in the United Kingdom, so knowing the local issues is important. Just these three EU countries alone encompass a number of regulatory distinctions; we will discuss some of these – in the areas of relevant transfers, consultation, consequences of non-compliance with consultation obligations and dismissals – in this article.

The directive applies to any 'relevant transfer', whether or not it is due to an agreement between two parties. There will be a relevant transfer when there is an operation within the EU, where the employer changes but the operation maintains its identity. Assessing whether this has occurred is complex, but the essence of the approach is to review each component of the business, such as buildings, equipment, staff, goodwill etc. A transfer within the meaning of the directive does not necessarily require a change of ownership in assets. In a recent judgment of 15 December 2005, the European Court of Justice held that a relevant transfer may occur even if equipment used by a service provider remains under the complete control of the original employer (eg security services at an airport).

There is no threshold for the size of the operation or number of employees involved. The law even applies to changes of employer within the same group of companies. Also, the fact that there has been one transfer does not bring an end to the matter. The law is triggered every time there is a change of employer, so it is critical to review what will happen at the end of the contract, however that arises. It is also important to consider any re-bidding where the contract could be awarded to another party.

While outsourcing transactions are frequently determined as being a 'relevant transfer', recent case law suggests various jurisdictions may have differing approaches. One of the more complex areas of outsourcing projects is identifying the issues and drafting agreements to account for a change of contract. For example, in France, an 'insourcing' situation – where a company takes back in-house a business operation that was previously outsourced – may not be deemed to be a relevant transfer whereas in Germany and the UK it could be, depending on the circumstances. Take the example of a company which wished to take over the cleaning and caretaking activities it had previously outsourced to a sub-contractor:

In France, current case law would suggest that such a reinstatement of these functions within the business would not be considered a relevant transfer and the company would not have to take over the sub-contractor's employees, as long as no significant transfer of assets takes place simultaneously (which will, in principle, be the case for cleaning or maintenance activities).

In Germany, the insourcing may constitute a relevant transfer depending upon whether a business unit is actually transferred from the sub-contractor to the client, with the cleaning and caretaking entity maintaining its economic identity. If, for example, the company only terminates the service contract with the sub-contractor, does not purchase any assets and uses its own employees to perform the required cleaning and caretaking services, this would indicate that there was not a relevant transfer. However, if the company employs certain key personnel of the sub-contractor and/or purchases some of its assets, the transaction might be deemed to constitute a relevant transfer.

In the UK the situation is currently broadly the same as Germany. It is necessary to examine carefully the nature of the transaction and determine whether it will be sufficient to simply terminate the service contract with the sub-contractor, or if particular employees and assets will be transferred. New regulations are due to come into force on 6 April this year which may change the UK position.

It is important to understand the scope, timescale and methods of the consultation which will need to be undertaken in each jurisdiction. In some states there will be a works council whose role will include regular discussion with management on significant issues, while in others it will be necessary to elect a body of employee representatives. Consultation can be made faster and more effective by ensuring that the work force have trained delegates with whom regular dialogue is maintained.

The information to be provided to employee representatives is specified in the directive. This is mostly supplied by the current employer but some details must be contributed by the prospective employer or transferee. The interpretation of the scope of this information differs from country to country. Information about the legal, economic and social implication for workers is set out with care and after a detailed analysis by the French and Germans and in short paragraphs in the UK. Germany has gone further than implementation of the directive: labour-management relations are governed by a set of rules that provide far-reaching rights for the works council, up to a full right to co-determination in particular cases.

Another area differing from country to country is the consequences of non-compliance with consultation obligations. In some European countries, this can render the transaction void and of no effect. For example, in France, the original employer can face criminal sanctions and works councils can suspend the transaction until the correct procedures have been followed. In Germany, the worker has the right to object to a transfer, with the result that his employment relationship remains with the original employer. In addition, in the typical outsourcing scenario where only a part of a business unit is transferred, negotiations with the works council on a so-called compromise of interests and – as the case may be – also on a social plan, may be required. In the United Kingdom, non-compliance usually leads to a financial penalty whereby an award of up to three months pay can be made to all affected employees.

> In the UK dismissals can be considered valid but unfair and compensation is payable – yet in France a discharge before the transfer is considered null and void and the employee can request to be re-instated with the new contractor or can seek damages

The directive prohibits the dismissal of employees in connection with a transfer, except for an economic, technical or other organisational reason. In practice this escape provision is very narrowly interpreted and so reducing the workforce before or after an outsourcing operation can be very difficult and time-consuming, which inevitably impacts on the cost savings that can be made. Moreover, the protection means that even carefully planned and executed re-sizing projects can be challenged in the courts. Parties need to factor this in, plan for any dismissals and agree a process for dealing with claims.

In the UK dismissals can be considered valid but unfair, and compensation is payable. Meanwhile in France, a discharge before the transfer is considered null and void and the employee can request to be re-instated with the new contractor or can seek damages. Before dismissing any workers after the transfer the new employer must follow specific procedures including, in some cases, consultation with works councils. In Germany, a dismissal is invalid if it was motivated by the transfer as such, however the former and new contractor are free to terminate employment relationships on other grounds, eg for operational reasons.

As we have seen, there are many distinctions throughout EU member states when dealing with outsourcing transactions. It is important to prepare thoroughly – that is, to consider the operation which is to be outsourced and evaluate the original location, method of operation, assets and process to determine whether there is a relevant transfer.

Outsourced contracts terminate for a variety of reasons – such as a serious default, a change of contractor or where the operation is brought back in-house – which will usually trigger a relevant transfer. Within Europe, whenever one of these stages arises or the employer changes, these laws are likely to bite and will continue to apply each time there is another change – so, agreements need to allow for those future stages.

Plan for consultation well in advance and seek advice from local lawyers as soon as possible. Check the consequences of non-compliance with consultation and make sure that any envisaged dismissals will satisfy the legal requirements of each jurisdiction.

In all cases where European employment regulations are involved, it is essential to understand the risk and where the liability falls, not just at the outset but for each future situation where the Acquired Rights Directive may come into play. Early analysis and preparation, as always, is essential. ■