

**What lessons can  
we learn from  
Carillion – and  
what changes do  
we need to make?**

# Executive Summary

## Why Carillion?

The compulsory liquidation of Carillion has created an uncertain future for the tens of thousands of workers and sub-contractors employed on contracts that Carillion held across public services, construction and transport infrastructure. And it also an anxious time for the clients, public bodies and end users that commission and rely on those services, as the Official Receiver seeks to find replacement contractors and joint venture partners to take over service and maintenance contracts and to complete construction projects.

The collapse of Carillion can be attributed to a range of factors, many resulting from the strategy employed by the company itself. Carillion became over-stretched, highly leveraged and, through under-bidding, left itself highly exposed to adverse outcomes on a small number of construction projects – risks exacerbated by aggressive accounting, mismanagement of pensions and prioritisation of dividend payments at all costs.

This event raises a number of questions that go to the heart of our political economy. How do we want companies to behave and what is the best form of governance to ensure that? What should our priorities be and how do we effectively support the workforce when companies go into liquidation? What role should private companies play in the delivery of our public services?

This report looks into each of these areas in turn, exploring what lessons can be learned from the collapse of Carillion and what changes we need to make to corporate governance, workplace rights and the outsourcing of our public services.

## Workplace rights

Too often directors and insolvency practitioners fail to consult with trade unions and worker representatives in insolvency situations. Workers and their representatives are often the last people to find out that their company is in financial trouble and their jobs are on the line. Frequently, the first time workers hear that their firm is at risk of going insolvent is through the national or local media. This leads to increased anxiety for people and a sense of powerlessness.

By this stage, it is often too late for their union to explore alternatives to business closure and options for saving jobs – be it through cost savings, by securing new orders or identifying profitable parts of the business which could be sold off.

So it was with the Carillion workforce, whose first inkling that the company was in serious trouble came when crisis talks were announced on 12 January only for the Official Receiver to be called in on 15 January. Although profits warnings had been issued in July and November 2017, at no point had the company sat down with recognised trade unions to discuss a rescue plan or ways of protecting the workforce.

But Carillion, is just one of a host of recent examples of large companies going insolvent. In recent years, many high street retailers have closed, leading to devastating implications for workers, their families and wider communities.

In this report, we explore how the law currently fails to protect the interests of workers, but instead is weighted in favour of the creditors, with the taxpayer too often expected to pick up the bill.

Due to the absence of early and meaningful consultation the workforce is denied a say over their future and can face substantial financial losses when their firm goes to the wall. Staff also do not have the time to explore alternative employment, before their pay cheques stop, meaning they need to depend on social security benefits.

Those who are transferred to new employers can miss out on basic protections for their pay and conditions. Others face difficulties recovering unpaid wages and holiday pay. Gaps in employment law also mean that those in insecure work, including agency workers, zero hours contract workers and the self-employed - who are most in need of a safety net - miss out on even the basic protections including the rights to recover monies owed to them by employers and to be consulted over their job.

In this report, we examine how UK employment law should be reformed to better protect working people and their families in insolvency situations.

## **Corporate governance**

Carillion's experience highlights ongoing flaws in the UK's corporate governance system, which requires directors to prioritise shareholder interests over those of other stakeholders, while relying heavily on investor oversight.

Carillion carried huge levels of debt, creating inherent risks to which its board, its investors and its auditors appear to have been oblivious. Investors were paid dividends and company directors were paid bonuses, with the approval of the auditor, while the company was heading towards disaster.

And, once again, sub-contractors, suppliers and the company's direct and indirect workforce have paid a heavy price for the failings of others.

The UK's corporate governance system is based on shareholder primacy: company law requires directors to promote the success of the company for the benefit of shareholders<sup>1</sup>. Company law also requires directors to consider the interests of other stakeholders, including employees, suppliers and local communities, in decision-making, but clearly prioritises the interests of shareholders over those of other company stakeholders.

## **Public service outsourcing**

The collapse of Carillion has intensified the debate about the role that private companies should play in the delivery of public services in the UK. With several other companies experiencing financial stress and with public confidence undermined by a growing list of

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<sup>1</sup> Section 172 of the Companies Act 2006

service failures, many are beginning to question the validity and purpose of public service outsourcing.

The collapse of Carillion is part of a series of high-profile failures involving private companies delivering public services, including:

- early withdrawal of the Stagecoach/Virgin franchise on the East Coast Mainline;
- Capita's chaotic performance with a national primary care support service for GPs;
- failure of Coperforma to provide effective non-emergency passenger transport services in the NHS;
- SERCO walking away from GP out of hours contracts;
- increasing performance problems in outsourced probation services.

Each of these areas has experienced unique issues but there are also commonalities. Each can be characterised by the failure to deliver on promised savings/revenue, under-performance against contract requirements and ineffective risk transfer, with the government and the taxpayer having to step in where services fail.

We believe the time has come for a change of direction. We need a new approach to public service commissioning, procurement and delivery. An approach that:

- puts public interest and the public service ethos at the heart of decision making, with public ownership and management as the default setting;
- provides full transparency about who runs our services and how they perform;
- ensures those providing services are accountable to the public and our elected representatives;
- is informed by the needs of public service users, communities and the public service workforce;
- promotes inclusive and high quality social, economic, employment and environmental standards;
- promotes sustainability and the highest standards of corporate governance and accountability for those organisations we choose to partner with.

The TUC shares the view of many that the publicly owned services provided by the public sector is the best way to deliver on these objectives.

In this section we ask the government to absorb the lessons from Carillion and other outsourcing failures and set out a new approach to public service commissioning and delivery around the following key priorities:

- Ensure a public interest case for initial sourcing decisions.
- Design commissioning and procurement strategies that promote social, economic, employment and environment standards.
- Increase transparency and accountability.

# Lessons for workplace rights

## Creating a culture where consultation is the norm

In workplaces across the country, UK managers regularly use the mantra that “the workforce is their greatest asset”. But unlike many other European countries the UK still lacks a culture of effective engagement with the workforce, with established information and consultation arrangements being the exception rather than the norm, especially in the private sector. In many EU countries, employment laws and the industrial relations systems support a culture in which joint problem sharing between management and unions is considered the norm.<sup>2</sup> In contrast in the UK, decisions on how companies are run and organised are taken by managers, with only limited engagement with the workforce. This is despite the wealth of evidence which shows information and consultation arrangements can make an important contribution to improving decision-making and building high performance workplaces. It also introduces basic democracy in the workplace and fosters greater trust between management and employees.

In countries such as Austria, Belgium, Norway, Romania and Sweden, consultation takes place on a continuous basis, with management providing workplace representatives with regular updates on strategic issues, including on the company’s financial position.<sup>3</sup> As a result, where companies are at risk of bankruptcy or insolvency, this rarely comes as a surprise to the workforce. By contrast, in the UK too often workers and their unions only become aware that their company may be in financial trouble when crisis talks are announced in the media or the administrators are called in.

Due to the absence of early and meaningful consultation the workforce is denied a say over their future and can face substantial financial losses when their firm goes to the wall. Staff also do not have the time to explore alternative employment, before their pay cheques stop, meaning they need to depend on social security benefits.

Those who are transferred to new employers can miss out on basic protections for their pay and conditions. Others face difficulties recovering unpaid wages and holiday pay. Gaps in employment law also mean that those in insecure work, including agency workers, zero hours contract workers and the self-employed - who are often most in need of a safety net - miss out on even the basic protections including the rights to recover monies owed to them by employers and to be consulted over their job.

More needs to be done to promote the role of regular information and consultation in the UK, ensuring that trade unions receive regular information about the financial status of companies and are consulted on strategic workplace issues, including business investment and rescue plans and decisions affecting staff deployment and pay and conditions.

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<sup>2</sup> TUC (2014) “*Democracy in the workplace: strengthening information and consultation*” available at: [https://www.tuc.org.uk/sites/default/files/Democracy In The Workplace 2014 .pdf](https://www.tuc.org.uk/sites/default/files/Democracy%20In%20The%20Workplace%202014.pdf)

<sup>3</sup> Eurofound (2009) “*Restructuring in bankruptcy: recent national examples*” available at: [https://www.eurofound.europa.eu/sites/default/files/ef\\_files/docs/erm/tn0908026s/tn0908026s.pdf](https://www.eurofound.europa.eu/sites/default/files/ef_files/docs/erm/tn0908026s/tn0908026s.pdf)

Workers should not just be consulted when redundancies are pending or parts of a business are to be outsourced (see below for discussion of these rights).

Current rights to information and consultation – found in the Information and Consultation of Employees Regulations 2004 (ICE) - have proved generally ineffective in creating a culture of consultation and engagement. This is largely because rights to consultation can only be triggered by a request from 10 per cent of the workforce - which is a very high bar in most workplaces, especially in undertakings with multi-work sites.

### ***Policy proposals***

As the recent Review of modern working practices recognised,<sup>4</sup> there is a clear case for reforming ICE regulations. But the TUC and unions believe that the government should go beyond the limited proposals set out in the Taylor recommendations. In our opinion:

- The threshold for triggering information and consultation negotiations should be substantially reduced.
- Employers should be required to enter talks about the establishment of information and consultation arrangements if requested by a recognised trade union.
- In non-unionised workplaces, a request by five employees should be sufficient to trigger negotiations on ICE arrangements.
- The penalties for failure to establish ICE arrangements or to inform and consult should be substantially increased, in line with protective awards, payable in collective redundancies consultation cases. And courts should have the power to issue status quo orders preventing employers from acting or requiring them to reverse decisions, until meaningful consultation has taken place.

### ***Need for early and meaningful consultation on redundancies and outsourcing decisions***

Employers have a legal duty to consult recognised trade unions (or workplace representatives in non-union workplaces) about proposed collective redundancies<sup>5</sup>.

If more than 20 employees' jobs are at risk of redundancy, employers must consult about:

- avoiding or reducing job losses (for example, by securing new orders, or selling all or part of the business)
- reducing the impact of redundancies (for example, assisting staff access to training)
- how much redundancy pay staff will receive.

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<sup>4</sup> <https://www.gov.uk/government/publications/good-work-the-taylor-review-of-modern-working-practices>

<sup>5</sup> Section 188 of the Trade Union and Labour Relations (Consolidation) Act 1992

The duty to consult generally still applies even where a business is at risk of or has become insolvent.<sup>6</sup> But the timing and nature of the consultation is critical if talks with unions are to play any role in rescuing the business, influencing the number of redundancies or even avoiding redundancies altogether.

Too often in insolvency situations, the duty to consult is overlooked or discussions only start *after* the employer has formulated their plans and the fate of the business has been decided. Often directors don't start consultations before insolvency practitioners are called in and the firm is on the verge of insolvency. Once appointed insolvency practitioners act as agents of the company and effectively step into the shoes of the employer. But by this stage, the chances for union officials to progress genuine business alternatives or to influence the employers' mind are significantly reduced.

UK law and practice does not help here, in three key ways.

Firstly, UK law suggests that employers should only start consultations when managers are *proposing* to make 20 or more employees redundant. In contrast, the EU Directive on collective redundancies (on which UK law is based) states the employers' duty to consult is triggered as soon as employers are *contemplating* 20+ redundancies. So under UK law the duty to consult kicks in at a much later stage in the decision-making process than is required by the directive.<sup>7</sup> This fact has not been missed by the courts who have pointed out that '*proposing*' goes beyond the mere contemplation of a possible event or '*the diagnosis of a problem and appreciation that at least one way of dealing with it would be by declaring redundancies*'.<sup>8</sup> Rather it involves laying before others '*something which one offers to do or wishes to do*'.<sup>9</sup> It is questionable whether the UK meets the requirements of EU. Indeed, the Employment Appeal Tribunal has suggested that UK legislation cannot be made to comply with the terms of the Directive '*without distortion*'.

Secondly, in 2013 the coalition government reduced the consultation period in cases of mass redundancies (involving 100+ redundancies) from 90 days down to 45 days - halving the amount of time employers and unions have to identify alternatives to business closures and job losses, before redundancy dismissal notices can be sent to employees. These changes were introduced even though the Workplace Employment Relations Survey 2011, found that in 40 per cent of workplaces that engaged in redundancy consultations, managers' original proposals were altered, leading to fewer redundancies, and extra help and pay for individuals facing redundancy.

Union case studies also highlight how during the economic downturn, many private sector employers engaged in meaningful consultation with recognised unions. The negotiated agreements achieved positive outcomes, including business rescues, reduced job losses, the retention of skilled workforces and assistance provided to those facing redundancies. For example:

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<sup>6</sup> The courts have not generally accepted employers' arguments that insolvency is a special circumstance so consultation need not take place.

<sup>7</sup> *MSF v Refuge Assurance plc and anor* [2002] IRLR 324

<sup>8</sup> *Hough v Leyland DAF Ltd* [1991] IRLR 194

<sup>9</sup> *MSF v Refuge Assurance Ltd* [2002] IRLR 324.

- At Bombardier, following the loss of the Thameslink contract to Siemens in 2011, the company announced mass redundancies, the closure of the Derby site and a review of their UK operations. Management met regularly, on at least a weekly basis, with recognised trade unions. The consultation period provided unions and management with the opportunity to identify and win new contracts, to review shift patterns and staffing structures. The company, unions and Government departments (including DWP and BIS) invited appropriate agencies to visit the site to assist in job search. As a result of the ongoing discussions, compulsory redundancies were avoided.
- During the economic downturn, unions worked with employers at Jaguar Landrover to avoid serious job losses and to protect the future of the company. Following lengthy consultation, unions and their members agreed a year pay freeze and a shorter working week. The unions also agreed to move labour between two plants to save jobs.

Thirdly, the current legal framework creates a disincentive for directors and insolvency practitioners to consult with trade unions and worker representatives where businesses are at risk of closing. Insolvency practitioners face a conflict of interest. They consider that their primary responsibility is to protect the interests of creditors, particularly those with secured debts. They face pressures from creditors, including banks and financial institutions and private equity firms, to wind the company up and release financial assets. The interests of employees are given secondary consideration.

Insolvency practitioners often conclude that the financial penalties for failing to consult are less than the costs of continuing to run the business during the consultation period – a view expressed by City Link directors following the firm’s closure January 2015.<sup>10</sup> The cost-benefit analysis is further weighted against consultation as the financial costs associated with the failure to consult are transferred to the taxpayer once the business enters insolvency. For example, after Woolworths went into administration, the appointed insolvency practitioners failed to consult with USDAW, the recognised union. Following a legal challenge, USDAW secured £67.8 million in protective awards for 24,000 Woolworths’ employees – a bill which was picked up the taxpayer.<sup>11</sup>

The absence of personal liability also means insolvency practitioners have no direct incentive to ensure that collective redundancies consultation takes place. Indeed, directors can be held personally liable if they continue to operate firms which are insolvent. The time available for consultation can also be severely curtailed because the company cannot afford to continue to pay the wages bill.

### ***Policy proposals***

Action is needed to ensure that unions and workforces can participate in timely and meaningful consultation where there is a risk of mass redundancies or business closure. Proposals for reform include:

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<sup>10</sup> House of Commons Committees Report on Impact of the closure of City Link on Employment. First Joint Report of the Business, Innovation and Skills and Scottish Affairs Committees of Session 2014–15. Published on 23 March 2015. London: The Stationary Office Ltd.

<sup>11</sup> <https://www.tuc.org.uk/news/cutting-redundancy-consultation-risks-increased-unemployment>



- Putting in place an early alert system to inform unions when strategic companies are at risk of insolvency. Early engagement with unions would provide the opportunities for unions, Ministers, the administrators and the companies to explore alternatives, including business rescues and the identification of new orders. It would also ensure that that staff get early access to support, training, redeployment.
- Ensuring that consultation with unions and workplace reps starts as soon as redundancies are being contemplated and reinstating the 90-day consultation period where 100+ jobs are at risk, to give unions and employers time to explore ways of avoiding redundancies.
- Reviewing the role and duties of insolvency practitioners to ensure that the interests of working people are protected and that insolvency rules do not limit or deter insolvency practitioners from consulting the unions and workplace representatives.
- Exploring practices used in countries such as Austria, Belgium and Germany and Slovenia, where managers and unions are given time to agree social plans in redundancy and insolvency situations which protect the interests of working people. Whilst social plans are being discussed, companies should be protected from creditors.

### **TUPE protections in insolvency situations**

The TUPE Regulations<sup>12</sup> are designed to protect workers who are affected by business transfers, where a company or part of a company is sold to another firm and where services are outsourced, where service contracts are awarded to a new contractor and where services are brought back in-house.

Under TUPE regulations:

- Employees' contracts of employment are transferred to the new employer;
- Employees' continuity of employment is preserved so they do not miss out on statutory employment rights;
- Employees' existing pay and conditions are protected, with the regulations limiting the ability of the new employer to reduce contractual entitlements;
- Employees benefit from additional protections from dismissal;
- Union recognition transfers to the new employer;
- Recognised unions (and workplace reps in non-union workplaces) have the right to be informed about potential transfers and consulted where the existing or future employer envisages making changes to transferred employees' pay and conditions.

Employees continue to benefit from TUPE rights in most insolvency situations (although see below for discussion on gaps in the rules).

Indeed in 2001, the EU Acquired Rights Directive – which underpins the UK TUPE regulations – was revised with a view to encouraging a 'rescue culture' where businesses

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<sup>12</sup> Transfer of Undertakings (Protection of Employment) *Regulations* 2006.

were at risk of bankruptcy and insolvency. The aim was to increase the chances of viable parts of insolvent businesses being sold as going concerns. This in turn would maximise the chances of employees retaining employment.

The revised Directive set out two options for national governments to legislate to:

- Ensure that employee related debts, such as statutory redundancy payments, payments in lieu of notice, and unpaid holiday pay, don't transfer to the new employer in insolvency situations.
- Allow the existing and future employers (and insolvency practitioners) to negotiate and agree changes to pay and conditions for transferring staff with a view to ensuring the survival of the business and the preservation of jobs.

The UK government decided to implement both options – a move largely supported by the TUC and trade unions.<sup>13</sup>

However, the revised EU Directive also stated that certain key TUPE employment protections could be disapplied in 'relevant insolvency proceedings' – that is where businesses are subject to bankruptcy and analogous insolvency proceedings instituted with a view to liquidating the company's assets under the supervision of an insolvency practitioner.

This means that in *some* insolvency situations, outsourced employees can lose out on key TUPE rights including:

- Their contract of employment does not automatically transfer to the new employer and their continuity of employment is not preserved. This means they could miss out on key statutory employment rights such as maternity and paternity leave, the right to request flexible working, statutory redundancy pay and unfair dismissal protection which only apply once an employee meets the relevant qualifying period.
- Their contractual entitlements are not protected, meaning the new employer can reduce their pay and conditions.
- Special protections from unfair dismissal, connected to the transfer no longer apply.

However, in such insolvency situations, union recognition agreements *still* transfer to the new employer and rights for recognised unions (and workplace reps) to be informed and consulted on transfers and redundancies are not affected.

These provisions have been widely criticised by lawyers on the basis that the regulations are not clearly worded and it is far from certain when or whether full TUPE rights apply in some insolvencies – especially where insolvency practitioners do not immediately wind up a business and sell the assets, but instead continue to operate the business and sell off viable sections as a going concern.

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<sup>13</sup> The TUC's main reservation about these provisions related to the ability of non-union reps, which lack the necessary agency or authority to agree changes to pay and conditions on behalf of the wider workforce.

In the case of Carillion much legal uncertainty remains over whether staff who have been transferred to new employers are entitled to full TUPE rights. Such uncertainty benefits no one. It creates confusion for employers and increases the risk of litigation – which in turn creates unnecessary costs of employers and unions. It also means that the affected workers are uncertain of their rights and therefore vulnerable to mistreatment.

### **Policy proposals**

The TUC believes the government should:

- Revise the 2006 regulations to make clear that full TUPE rights apply to all employees who are transferred to a new employer during an insolvency situation. These legal changes however would only benefit employees affected by future insolvencies.
- The Cabinet Office should agree to issue a Statement of Practice which confirms that all Carillion staff working on public sector contracts are entitled to full TUPE protections.

### **Missing out on pay protection**

Where a company goes insolvent, working people will often face significant financial losses.

Currently the law places significant limits on the financial guarantees provided to employees where their employer goes insolvent. In theory, it is possible for employees to claim unpaid wages (up to four months), unpaid holiday pay and other entitlements from their insolvent employer, in their capacity as preferred creditors.<sup>14</sup> But the maximum sum payable to employees in the form of preferential debt is £800, plus any unpaid holiday pay. This £800 limit almost invariably fails to cover the actual amount owed to employees.

In practice, employees also find it very difficult to recover any payments through this route. Employees' preferred creditor status is only ranked equally with claims from other preferred claimants. Often prior claims from creditors with a fixed charge on the company's assets will take precedence. Where employees are owed more than £800 in unpaid wages, their claims only rank alongside other unsecured creditors. Usually there are insufficient funds remaining to cover all outstanding debts. Employees also are likely to face serious delays before any payments are made.

As a result, employees must mainly rely on payments from the Redundancy Payments Office (RPO) in insolvency situations. But claims from the RPO are also capped. This means employees often cannot recover money which they are owed. For example, employees can only claim for a maximum of 8 weeks' unpaid wages (including any protective awards if the employer failed to consult on collective redundancies). And each weeks' pay is currently capped at £489. Recent figures published by the Office of National Statistics Annual Survey of Hours and Earnings (ASHE) 2017 reveal that median gross weekly earnings for full-time employees in the UK were £550. So it is inevitable that employees made redundant as a result of an insolvency will lose out.

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<sup>14</sup> Under section 386 of the Insolvency Act 1986.

Employees also lose out on contractual rights to holiday pay and sick pay which exceed the statutory minimum of £489 a week.

But the limits of financial protections for working people do not end there. Many of those who are most vulnerable within the labour market, including agency workers, those on zero hours contracts, dependent contractors and freelancers may not be able to recover any money owed to them from the RPO. This is due to their uncertain employment status.

### ***Policy proposals***

The TUC believes that in the event of their employer's insolvency, all working people should be able to recover all forms of remuneration owed to them by their employer in full. This includes all unpaid wages, holiday pay, notice payments, maternity, paternity and parental leave pay and any outstanding sick pay. Employees should also be able to recover any protective awards owed to them due their employers' failure to consult on redundancies or TUPE transfers.

Such financial guarantees would not only ensure individuals receive what they are legally owed. More importantly, it would assist working people and their families to meet their housing, fuel and food bills whilst they look for new employment or seek training to help them find a new job.

We therefore call on the government to take urgent action to:

- Remove the current limits on the amounts which workers can recover from the RPO.
- Ensure that all working people, including agency workers, those on zero hours contracts and the self-employed, can also recover unpaid wages etc from the insolvency service. Currently, the ability to apply to the insolvency service is limited to 'employees'.

## Lessons for corporate governance

Carillion's experience highlights ongoing flaws in the UK's corporate governance system, which requires directors to prioritise shareholder interests over those of other stakeholders, while relying heavily on investor oversight.

Carillion carried huge levels of debt, creating inherent risks to which its board, its investors and its auditors appear to have been oblivious. Investors were paid dividends and company directors were paid bonuses, with the approval of the auditor, while the company was heading towards disaster.

And, once again, sub-contractors, suppliers and the company's direct and indirect workforce have paid a heavy price for the failings of others.

### **The role of shareholders in the UK's corporate governance system**

The UK's corporate governance system is based on shareholder primacy: company law requires directors to promote the success of the company for the benefit of shareholders<sup>15</sup>. Company law also requires directors to consider the interests of other stakeholders, including employees, suppliers and local communities, in decision-making, but clearly prioritises the interests of shareholders over those of other company stakeholders.

This is the context in which the Carillion board allocated the company's revenues and used the vast loans the company carried.

Until the summer of 2017, Carillion paid dividends every year. In 2012, the company's cash flow became negative; but despite this, dividend payments went up each year, despite the ups and downs of the company's cash income. From 2012 to 2016 - during which the company was cash negative in 2012, 2013 and 2016 - Carillion's paid out £376 million in dividend payments, while generating only £159 million in cash. In 2016, when Carillion lost £38 million in cash, the company paid its highest ever level of dividends of £78.9 million. Put like this, it is clear that the company was effectively using debt to pay dividends.

If the board had decided to pay no dividends from 2012, the company would, everything else having been equal, have been £375 million better off in the summer of 2017 and better able to withstand the financial pressure it was under.

In addition, the fact that dividend payments were not only paid but rose year on year<sup>16</sup> contributed to investors (and others) failing to realise that the company was facing severe financial problems. Inadvertently, or not, it acted as a disguise for the company's situation.

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<sup>15</sup> Section 172 of the Companies Act 2006

<sup>16</sup> See figures in 'The Collapse of Carillion' House of Commons Library Briefing Paper Number 8206, 14 March 2018 <https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-8206#fullreport>

It is important to note that this is a relatively common practice among listed companies; research has shown that companies continue to pay dividends, even when not justified by company performance.

An important reason for this is to guard against a hostile takeover. UK companies are uniquely exposed to hostile takeovers; companies in Continental Europe have greater protection through larger block shareholdings and other mechanisms including stronger institutions for workers' voice, while in the US so called 'poison pills' that allow boards to rebuff hostile takeover approaches are allowed by law. The greater vulnerability of UK companies to hostile takeovers shows in the figures: between 1998 and 2005, takeovers of Japanese companies equated to 2.5 per cent of GDP, of German companies 7.5 per cent, of French 9 companies 9.9 per cent, of US companies 10.7 per cent, while takeovers of UK companies equated to 21.8 per cent of GDP<sup>17</sup>.

The main way that a UK company can protect itself from a takeover bid is to maintain a high share price to raise the cost of a potential takeover. For a company with dispersed and therefore relatively mobile shareholders, as is typical of the vast majority of companies listed on the UK stock market, this is not compatible with cutting or suspending dividends.

The TUC has set out elsewhere our analysis of the problems of the UK's merger and takeover regime and our proposals for reform. We (and others) have argued that the pressure to maintain dividend payments leads to lower levels of investment in R&D, and this is backed up by research by the Bank of England<sup>18</sup>.

It is also worth noting that the company expanded rapidly through a series of mergers and acquisitions, contributing to the complexity of its structure, which appears to have been a factor in the widespread failure to understand the precarity of the company's situation.

Shareholders have significant rights in relation to corporate governance and as a result play a major role in the UK's corporate governance system. This has led to important areas of corporate practice being left to shareholder oversight, rather than regulation, to monitor and manage, as a matter of public policy. For example, in relation to executive pay, successive governments have chosen to strengthen disclosure requirements and shareholder voting rights on executive pay, rather to regulate directly. Very significantly, company annual reports, while required by law, are addressed to shareholders, rather than regulators or the public. The role of regulators in monitoring annual reports is extremely limited and the sanctions taken against reports that do not comply with legal requirements are negligible.

There are two main problems with reliance on shareholders as a substitute for direct regulatory oversight.

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<sup>17</sup> Jackson, G and Miyajima, H (2007) *Varieties of Capitalism, Varieties of Markets: Mergers and Acquisitions in Japan, Germany, France, the UK and USA*, RIETI Discussion Paper Series 07-E-054, London: RIETI, in Aeron Davis et al, *Takeovers and the Public Interest*, Policy Network, July 2013

<sup>18</sup> Are firms underinvesting – and if so why? Speech given by Sir Jon Cunliffe, 8 February 2017  
<http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech957.pdf>

Firstly, many institutional investors hold shares in hundreds, if not thousands, of companies. There are therefore practical limitations on their capacity to absorb information from all the companies in which they hold shares and to engage with companies over the range of areas for which they are ultimately responsible.

Secondly, even where investors do devote the required time to monitoring and engagement, their ultimate sanction against a company where they have concerns is to sell their shares. These problems are graphically illustrated by the collapse of Carillion.

It is clear that most of Carillion's shareholders did not pick up on the problems the company was facing. Other than a few hedge funds, who were alerted by the company's late payments of suppliers, the company's share price shows that the majority of investors were not aware of the precarious situation the company was in prior to its statement in July 2017. At Carillion's May 2017 AGM, the company received the support of over 98 per cent of shareholders for its pay policy resolution. Approximately 80 per cent of shareholders supported the company's remuneration reports in the last two years.

However, even if investors had understood the poor state of Carillion's finances earlier, their likely response would have been to sell their shares, thus reducing their exposure to the situation. This would have done nothing to protect workers and suppliers from the company's weakening position.

The fiduciary duties of investors are owed to their beneficiaries, rather than to the companies in which they hold shares. They are not responsible for the interests of company workers, suppliers, communities and other stakeholders – yet these stakeholders have suffered extensive losses from Carillion's collapse. Workers, suppliers, creditors, communities and the wider public all rely on high standards of corporate governance and practice, but have no rights within the UK's corporate governance system. Shareholders have extensive corporate governance rights, but have no legal responsibility towards the interests of other company stakeholders or to act in the long-term interests of the companies in which they invest. This is a contradiction at the heart of the UK's corporate governance system.

The dysfunctionality of this system is illustrated by the role of BlackRock, a significant investor across the whole FTSE index. Blackrock was the investment manager for Carillion's DC pension scheme, but was shorting Carillion as far back as 2012, and increased its short positions in 2017<sup>19</sup>.

The experience of Carillion clearly demonstrates that shareholders cannot be relied upon to act as a quasi-regulator in relation to corporate behaviour. At the first oral evidence session of the Work and Pensions and BEIS Parliamentary Committees' Joint Inquiry into the collapse of Carillion, MPs showed surprise that the Financial Reporting Council did not have a greater direct responsibility for monitoring the quality of the company's reports and audits. And the public debate around corporate crises shows that public expect the government to act directly in relation to corporate malpractice.

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<sup>19</sup> <https://www.unison.org.uk/news/article/2018/02/potential-carillion-conflict-interest-requires-proper-investigation-says-unison/> and <https://www.ft.com/content/0d0f689c-0513-11e8-9650-9c0ad2d7c5b5>

## **Policy proposals**

The collapse of Carillion exposes the problems and risks of the reliance on the role of shareholders within the UK's corporate governance system. The TUC is calling for the following policy proposals to address shareholder primacy and the reliance on shareholder oversight:

- Reform directors' duties to make promoting the long-term success of the company the primary duty of directors. In addition, directors should be required to have regard to the interests of workers, shareholders, suppliers, communities and other stakeholders.
- Worker directors should comprise at least one third of the board of companies with more than 250 workers.
- Investors' corporate governance rights should be subject to a minimum period of share ownership of at least two years.
- Reform the mergers and takeovers system to ensure that it operates in the long-term interests of the target company (for more detail on this proposal, see Mergers and Takeovers - Proposals for Reform, TUC)
- Create a standing Corporate Governance Commission with stakeholder representation, tasked with keeping corporate governance policies and practice under review. As well as promoting high standards of corporate governance, the Corporate Governance Commission should have powers to hold directors to account for non-compliance with Section 172 and the other parts of directors' duties. It could potentially have a wider role in relation to enforcement, in particular in relation to areas where the inability or lack of inclination of shareholders to intervene leaves a gap in terms of the public interest.

## **Audit, accounting and reporting practices**

As has been widely noted in the media, KPMG signed off Carillion's accounts every year since 1999. Yet its audit of the company's 2016 accounts apparently did not spot any major problems, despite the fact that six months later the company announced a major profits warning and descended into terminal decline.

Clearly, companies' fortunes can change, and sometimes suddenly. But it now appears clear that the problems that led to Carillion's downfall stemmed from business decisions taken over a number of years and that the company's financial position was already vulnerable.

A key issue is how the company's debt was presented in the accounts. A House of Commons (HoC) Library Briefing Paper on the Collapse of Carillion<sup>20</sup> has calculated, based on Carillion's annual reports and financial statements, that from December 2009 to January 2018 the total owed by Carillion rose from £242 million in December 2009 to an estimated £1.3 billion in January 2018. The HoC briefing includes two charts which set out the rise in

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<sup>20</sup> 'The Collapse of Carillion' House of Commons Library Briefing Paper Number 8206, 14 March 2018  
<https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-8206#fullreport>



Carillion's loans alongside Carillion's revenue and assets, which in both cases were dwarfed by the size of the company's debt.

Yet, in Carillion's 2016 Annual Report<sup>21</sup>, the board's assessments of its principal risks, on which the auditors are required to comment, makes no mention of financial stability or the high level of debt the company carried. "Work winning" is given as the company's highest risk and contract management as its second highest.

For nine out of the ten principal risks outlined in the report, 'financial strength' is noted as a relevant factor. In the key outputs section, the board reports on Carillion's financial strength as follows:

"Delivering profitable growth with cash-backed profit in order to provide attractive returns for our shareholders and continue investing in our business to support our strategy for growth, while maintaining a robust capital structure and the confidence of the debt and equity markets".

This statement is hard to square with what is now known about the size of the company's debt relative to its revenues.

Another key issue is how profits were presented in the accounts. It has been widely reported that Carillion engaged in so-called 'aggressive accounting' – booking profits before they are realised. This practice is not unique to Carillion and has contributed to other corporate scandals, notably Tesco's profits restatement in 2014 and subsequent fine of £129m.

Regardless of the potential or otherwise for Carillion's contracts to have ultimately become profitable, the company had clearly run out of cash and had taken on huge debts. Again, the accounts did nothing to highlight this to readers.

This leads to the question of whether KPMG simply did a bad job, repeatedly, and/or whether there are weaknesses in accounting and audit requirements that meant that critical issues such as the rise of the company's level of debt and lack of cash were insufficiently examined and highlighted.

Carillion's use of KPMG since its inception and KPMG's failure to detect or highlight the company's underlying financial vulnerability over that period has reignited concerns about the rotation of audit companies and lack of choice in audit market. Only the big four audit firms are considered to have the capacity to manage audits of large FTSE companies. This leads to a lack of choice, particularly for large companies, in the audit market.

However, creating more competition in the audit market is unlikely to have a positive impact on audit quality unless conflicts of interests in the audit market are addressed and weaknesses in accounting standards are addressed.

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<sup>21</sup> Carillion plc Annual Report and Accounts 2016 <https://carillionplc-uploads-shared.s3-eu-west-1.amazonaws.com/wp-content/uploads/2017/03/0930AQ-carillion-annual-report-2016-original.pdf>

The big four audit companies also dominate the market for supplying remuneration services and business advisory services to companies. This creates a clear conflict of interests for auditors in their dealings with their clients.

### **Policy Proposals**

- Audit companies should not be permitted to engage in contracts for other business services with their clients.
- An inquiry into reporting, accounting and audit practices that contributed to the financial problems of Carillion being recognised for so long should be set up. Its scope should include the practice of booking profits before they are realised, a lack of focus on cashflow and debt within accounting and audit.
- The inquiry should aim to establish clear rules in relation to the practice of booking profits before they are realised.
- In addition, it should aim to produce proposals for reporting on debt and cashflow, with a particular focus on companies whose business model requires lumpy payments and revenue generation.
- Companies should be required to publish a pie chart showing how their revenues have been allocated, including dividends, R&D, executive remuneration and workforce pay.
- Companies should be required to publish a pie chart showing how their cashflow has been generated, including the use of debt.

### **Company structure and size**

A key question is how far the former Carillion board were aware, individually or collectively, of the true financial health of the company. If they were, this clearly raises serious issues relating to company mismanagement and potentially fraudulent statements to the market. However, if they were not aware of the true position, the implications are, if anything, even more serious. It is vital to try to understand how and why this came about to try to prevent a repetition of Carillion's experience in the future.

Carillion plc was comprised of over 300 companies. In the context of its sudden collapse, it is vital to examine the purpose and effect of the company's corporate structure. It seems highly likely that the complexity of Carillion's corporate structure contributed to directors and staff failing to understand the company's true financial position. It is important to note that Carillion's structure does not appear to have given its subsidiary companies protection against their parent company's collapse.

It is common for large companies to operate through large numbers of subsidiaries. There have long been suspicions that companies use complex structures for tax purposes. Added to this is the question of whether subsidiary structures also act to dilute corporate governance responsibilities, transparency and accountability.

### ***Policy Proposals***

- There should be further investigation, perhaps by the BEIS Parliamentary Committee, into the impact of corporate structures on corporate governance and transparency.

### **Business model – low margin contracts combined with excessive debt**

Carillion's business model appears to have been based on bidding at low margins in order to win contracts and using high levels of debt in order to post profits in its accounts.

Low margin contracts can create risk, in that small changes in costs or revenues can easily dent the overall profitability of a particular contract. In addition, they create a need to squeeze sub-contractors, thus passing a low-margin model down the supply chain to workers who experience insecurity and often miss out on employment rights due to precarious forms of employment such as zero hours contracts and bogus self-employment. Ultimately, a business model based on undercutting other bidders and then squeezing costs through the supply chain is not compatible with responsible business practice.

As has already been highlighted, Carillion was carrying very high levels of debt, which appear to have been necessary in order for the company to continue to post profits and to have masked the poor returns generated by some of the company's contracts. High levels of borrowing are particularly risky when combined with low margin contracts.

Carillion's collapse raises questions about the viability of its business model over many years, and points to the need to adopt a different model of outsourcing, which we turn to in the next section.

# Lessons for public service outsourcing

## What does Carillion tell us about public service outsourcing?

The collapse of Carillion and subsequent profit warnings by other strategic suppliers such as Capita, have raised considerable concerns about the sustainability of the current model of public service outsourcing.

In an attempt to reassure the public, MPs and investors (not necessarily in that order), Cabinet Office Ministers were quick to establish the government's narrative on Carillion which was based on four propositions:

- This was a failure of a private sector company and it is the company's shareholders and lenders who will bear the brunt of the losses, there was to be no taxpayer bailout.
- The cause of Carillion's financial difficulties was not connected to its government contracts but to failures within other parts of its business, specifically construction within and outside the UK.
- The apparent financial stress encountered by other strategic suppliers is being successfully managed. Capita's profit warning was part of a balancing sheet strengthening exercise.
- The government will therefore continue to source services from the private sector in order to leverage the expertise of specialist providers and to deliver value for money for taxpayers.

However, this partial explanation fails to address some of the key concerns that arise from the model of outsourcing encapsulated by the Carillion model.

- While the financial crisis came to a head as a result of the £845m hit to profits arising from its construction business, it was poor decision making in previous years that led to serious trouble<sup>22</sup> – decision making that was driven largely by the need to maintain dividend payments and protect share price. The ability to cross subsidise was limited by this and by low margins on public sector contracts
- This approach resulted in part from a model of outsourcing that has created giant conglomerates focussed on winning new contracts, accelerated through acquisitions.
- This process leads to very large and complex provider companies bidding for contracts and entering new areas of service where they have limited or no history of expertise or specialism.
- The scale and diversity of the portfolio means that problems in one area of business can have rapid contagion into other areas, putting a whole range of public services, public service workers and sub-contractors at risk.

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<sup>22</sup> *The collapse of Carillion*, House of Commons Library Briefing, January 2018

- The nature of these services means that it is incumbent on the state to maintain their provision and manage the transition process in the event of a collapse or early termination of contract which means that the taxpayer does, indeed, bear a significant cost burden resulting from the private sector company failure.
- The scale and nature of outsourcing means that the market for public services is dominated by large private sector providers with similar business models (or at least have similar investor and financial market defined priorities) that are highly dependent on public contract revenue and are thus similarly exposed to downside risks arising from a period of prolonged government austerity. The prevalence of profit warnings and financial stress among a significant proportion of strategic suppliers gives grounds for genuine concern.
- The complexity and number of contracts across the family of businesses and subsidiaries within the Carillion group and its extended supply chains that has emerged since the collapse demonstrates (a) the sheer scale of public services that have been outsourced to private providers of this kind and (b) the opacity and lack of information that is open to scrutiny in the public domain.

In their analysis of public service outsourcing in the UK, Bowman et al describe this model of outsourcing as follows:

“Outsourcing firms must continuously bid for new contracts to sustain revenue and most contracts have a short, fixed life. Renewal is uncertain in a world where government commitment to create competitive outsourcing markets means firms cannot be sure of winning any bid (even re-tenders). To deliver revenue growth, outsourcers must therefore add new and larger contracts, which often means bidding or buying into unfamiliar areas where senior management has no operating competence and contracts are often linked to policy reform, which provides a degree of novelty in the operating environment. Contracts can always be won by underbidding, which boosts revenue but not earnings”<sup>23</sup>

As we discuss elsewhere in this report, this model is exacerbated by the UK’s corporate governance system that is based on shareholder primacy, with directors required to promote the success of the company for the benefit of shareholders over other stakeholders.

And, to the extent that the ‘success of the company’ can be realised in different ways and according to different timescales, requiring that directors promote the success of the company for the benefit of shareholders can and does encourage board decision-making that is skewed towards short-term financial returns, rather than investing in long-term and sustainable company growth.

It was this toxic combination of relentless growth through new contracts and acquisitions and the need to provide short-term financial returns to shareholders that drove the aggressive accounting practices and reckless debt accumulation that led to the downfall of Carillion.

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<sup>23</sup> *What a waste: outsourcing and how it goes wrong*, Bowman et al, 2015

The history of public service outsourcing in the UK over the last five years (and in particular the last 12 months) shows that these principles and practices are not confined to Carillion, that other strategic suppliers including SERCO, G4S and Capita have experienced similar financial problems and adverse reactions from capital markets and that the accountability of these large private providers that dominate public service outsourcing remains problematic due to the opacity, complexity and confidentiality behind which so much information remains hidden. To put it bluntly “the outsourced state” remains unknown, unexamined and unaccountable not only to many citizens but also to our elected representatives.

But it would be wrong to say that this is an exclusive failing of the corporate practice of outsourcing conglomerates. In many respects, this is a creation of the nature of commissioning and procurement policy in the UK over thirty years where, despite several reboots, price based competition and aggregation of services within larger contracts has predominated. This situation has intensified in more recent times by the drive for rapid cost savings in response to public spending cuts and with commissioners seeking to significantly tighten up contracting terms to make amends for perceived past failings.

There was evidence to suggest that Carillion deliberately submitted abnormally low tender prices in order to win contracts. However, competitive tendering of services means that public sector commissioners looking for short-term savings effectively collude with those companies underbidding in order to seek market advantage thereby driving prices down to unsustainable levels.

And while cost savings may have been made on the face value of the contract, these costs are then managed by the contractor in ways that off-loads risk to others – through the suppression of wages, terms and conditions of the outsourced workforce, the use of insecure forms of employment in supply chains and the almost punitive treatment of sub-contractors. But also through a focus on high turnover, low resource provision of services, hence the rise of 15-minute visits in domiciliary care, as one example.

And, of course, risk is also transferred to other parts of the public sector – the suppression of the wages of outsourced workers leads to an increased in-work benefits bill, the scaling back of adult care services to a bare minimum means more older people requiring NHS support.

It is our view that, despite government attempts to isolate it, the case of Carillion does indeed shine a light on the nature of public service outsourcing. And what we discover is highly problematic for our public services - those who deliver them and those who depend on them - for taxpayers and citizens and for large parts of our economy that have become locked into a spiral of unsustainable prices, fragile business models and the exploitation of workers and sub-contractors.

This requires a change of direction by political leaders at a national and local level and by those who design and implement commissioning and procurement strategy across the public sector.

We therefore ask the government to absorb the lessons from Carillion and other outsourcing failures and set out a new approach to public service commissioning and delivery around the following key priorities:

- Ensure a public interest case for initial sourcing decisions
- Design commissioning and procurement strategies that promote social, economic, employment and environment standards
- Increase transparency and accountability

### **Make or buy: a public interest case**

In their recent report on public service outsourcing, Tizard and Walker define good commissioning practice as follows:

“When the public sector commissions this is to identify need based on assessments, consultation and policy objectives; allocating money to meet them; identifying the best means of meeting needs. Being a good commissioner is no mean feat. It is a different activity from procurement, although commissioning can lead to decisions on whether to “make or buy” – to provide in-house or let a contract”<sup>24</sup>

The TUC supports their recommendation for a clear set of “make or buy” criteria to apply to all commissioning decisions.

The decision on when to outsource the delivery of public services must take into account two key issues. First, a point of principle about the nature of public services, the purpose they serve and the expectations that derive from that – with the public interest as the primary objective. Second, a set of practical issues that arise from the ‘principal-agent’ relationship at the heart of outsourcing which becomes particularly problematic when sourcing complex, relational services.

Our starting point would therefore be to state that public services are fundamentally different from other commodities and personal services. They provide benefits to both individual service users and wider society, they are paid for by the general public, they are ours by right and they promote social justice and equality through their universal and redistributive nature.

The founding principles of public services, namely universal access, delivery according to need, services free at the point of use and services delivered for the public good rather than for profit should be at the heart of any model of service delivery.

It is our view that through its democratic accountability, collective funding through taxation and long-term integrated approach, the public sector is best placed to provide public services that meet the criteria above. Public sector provision should therefore be the default setting unless a set of public interest criteria makes an explicit case for the benefit of outsourcing.

However, there are also a set of practical considerations that apply to the outsourcing of public services that should also inform our approach to outsourcing. Where there is an “arms-length relationship between commissioner and provider under what economists call

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<sup>24</sup> *Out of contract*, John Tizard and David Walker, Smith Institute, January 2018

conditions of imperfect information” and where “the harder performance is to monitor, and the more complex the service being provided, the less well a principal-agent relationship performs compared with vertical integration”.<sup>25</sup>

The Institute for Government sets out ten considerations that “those introducing, adapting or overseeing contractual mechanisms in public services should ask to gain a better understanding of their costs and benefits”.<sup>26</sup>

### **When to contract? The Institute for Government**

**1. Is it difficult to measure the value added by the provider?**

If a service lacks objective or quantifiable measures of the value added by the provider, it will be more difficult to price contracts and monitor performance.

**2. Are service outcomes highly dependent on the performance of other services?**

If services that depend on one another to achieve their outcomes are contracted out to competing organisations, it may be more difficult to incentivise and secure the necessary cooperation between providers.

**3. Does delivering the service require investment in highly specific assets?**

If a service requires investments in highly specialised physical or human resources, government may find it costly to attract providers and, over time, could be left vulnerable to an incumbent provider with excessive market power.

**4. Is the service characterised by high demand uncertainty?**

If demand for a service is not known in advance, or subject to unpredictable variation, government may find it costly to incentivise investments and/or may be left vulnerable to ‘hold-up’ situations.

**5. Is the service characterised by high policy uncertainty?**

If there are politically motivated changes in policy direction or service specification, the government may find it costly to renegotiate contracts.

**6. Is the service inherently governmental?**

If a service involves making key policy decisions, is central to government’s law and order capability, or intimately related to government’s duty to protect the public, contractual mechanisms are unlikely to be appropriate.

**7. Is there an existing supply of high-quality providers?**

**8. Is there an existing workforce (either in the public or private sectors) with adequate skills and capabilities to deliver high-quality services?**

**9. Does the government have the organisational capability to design and monitor the use of contractual mechanisms?**

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<sup>25</sup> *The Shrinking State*, Landman Economics, March 2011

<sup>26</sup> *When to Contract?*, The Institute for Government, January 2013



They state that while there are strategies that can help mitigate some of the risks, “such mitigations typically entail additional costs, which policy makers and commissioners must factor in when making judgements on the respective value for money of contractual mechanisms and ‘in house’ service delivery”. And that policy makers and commissioners must consider “costs and risks of transition in service areas where contractual mechanisms are being introduced for the first time, or where they are being significantly extended or adapted”<sup>27</sup>

It is our view that this framework has not been systemically or consistently applied across the public sector. Public service outsourcing has too often been a response to top down policy direction and/or motivated by the search for short-term cost savings which has resulted in few of the purported benefits – efficiency, value for money, risk transfer, service improvement – being achieved.

Interestingly, this view is endorsed by arguments that have been employed by the outsourcing industry itself.

In their written submission to the Public Administration and Constitutional Affairs Select Committee inquiry into the collapse of Carillion, SERCO argue that contractors are ill-suited to deal with the risks associated with public service delivery.

“In recent years Government has used this monopoly-buyer position to achieve the transfer of risks to private companies that are essentially “state risks” which the suppliers have no way of mitigating or managing. Risks on contracts with a life of ten years in which any “Change of Law” is the suppliers’ risk (and how does that work with Brexit, or the Government’s ability to vary the Minimum Wage?); risk on volumes, which the suppliers have no way of controlling (e.g. Community Rehabilitation Companies); risk on the numbers of roads to be dug up to provide cycle lanes (Prisoner Escorting); risk Government payments are deemed to be illegal state aid; contracts in which the penalty for not repairing a £200 heater in a flat within a few days is more than the cost of buying the flat itself; risk where one arm of Government (the customer) makes a private company contractually liable, and subject to financial penalty, if another arm of Government does not perform its statutory obligations; risk that the information supplied by the Government as part of the tendering process is materially incorrect. When Government complains that when a contract fails, the risk they thought they had transferred to the supplier comes back, it is most often because that risk was of a type that should never have been transferred to the supplier in the first place.”<sup>28</sup>

Based on his extensive engagement with the executives of outsourcing companies, Professor Gary Sturgess states in his response to the same inquiry that “company executives were gravely concerned at government’s attempts to transfer risks which they were not able to manage”. These risks included “policy risk, state-aid risk, unlimited liability, excessive performance bonds, break clauses without costs, responsibility for ensuring cooperation with other government agencies, long-term capital risk in short-term contracts”.

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<sup>27</sup> *ibid*

<sup>28</sup> *Written submission to PCAC Select Committee, SERCO, March 2018*

He states that one of the most important insights from his research was “the need for government and industry to recognise that the procurement and contract management tools that are appropriate for buying ‘paperclips’ – highly commoditised, easily specified goods and services – are not appropriate for commissioning complex support services and front-line human services.”<sup>29</sup>

The British Institute of Facilities Management also highlight a number of adverse impacts on individual providers and the provider market more broadly that result from current commissioning models. This drives them to state that “if outsourcing cannot provide a better service, for good monetary value and for less risk, then it should not be done”.<sup>30</sup>

The conclusion drawn by each of these submissions is that new partnership approaches to commissioning and procurement should be adopted. Professor Gary Sturgess argues that “contract form should follow service function” and that “policymakers must distinguish between those markets that have developed to the point where they are capable of commoditisation and those where the complexity of or uncertainty about the services in question and/or a general lack of understanding or expertise on the supply side requires a much less transactional approach” (our emphasis). The conclusion is that if “the market for complex public services is to recover, it is essential that government work with industry to rebuild personal, organisational and institutional trust”.<sup>31</sup>

If the government’s priority is to ensure that the market for public services recovers, then there is merit in this approach. But given the industry’s own admission that is ill suited to manage the risks associated with the delivery of complex, relational services that are dependent on public policy decisions and interaction with other government services, it is not self-evident that that the government’s priority should be on maintaining the market. The Institute for Government’s criteria would suggest that this would be a classic case of when not to outsource.

This then begs the question, what is the added value that outsourcing conglomerates bring to public service delivery? Or, more bluntly, why outsource? Writing in *The Guardian*, Phil McDuff argues that a “sufficiently regulated private sector company whose only client is the government is indistinguishable from a public-sector body, raising the question of what the purpose of making it privately owned was in the first place”<sup>32</sup> This argument might be even more prescient, if we decide that the risk that is inherent in the provision of public services cannot be transferred to the outsourced provider.

We would argue that the government’s priority should be less on recovering the outsourcing market but in recovering public trust that the services we own are being delivered in accordance with the public interest.

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<sup>29</sup> *Written submission to PCAC Select Committee*, Professor Gary Sturgess, March, 2018

<sup>30</sup> *Written submission to PCAC Select Committee*, BIFM, March 2018

<sup>31</sup> *Written submission to PCAC Select Committee*, Professor Gary Sturgess, March, 2018

<sup>32</sup> <https://www.theguardian.com/commentisfree/2018/feb/28/futile-firms-run-public-services>

To that end, we would agree with SERCO when they argue that “the best mechanism of policy delivery should be chosen on a case-by-case basis through a robust, national, documented and publicly accountable “make or buy” decision-making process to determine what delivery mechanism is likely to produce the best outcome for the taxpayer and service users”.<sup>33</sup>

The job then is to determine how those criteria are informed and defined in a way that captures the full benefits for taxpayers and service users. There is a wealth of evidence already accumulated from public bodies, including local authorities, that have undertaken in-sourcing of previously tendered services that can be used to inform those criteria, ensuring that they are rooted in real world experience.

We must also consider what scope they may be for consultation with service users, public service workers and other stakeholders in determining the public interest case. And then how such criteria can be disseminated across the public sector to ensure consistency of application and practice at a national and local level.

### ***Policy Proposals***

- The government should identify a set of “make or buy” public interest criteria that explains how the delivery mechanism chosen best promotes:
  - a public service ethos;
  - accountability to service users and elected representatives;
  - value for money in the round;
  - quality service standards;
  - long- term sustainability of the service;
  - high quality employment conditions and practice;
  - integration of services.
- These criteria should be applied to all significant commissioning decisions across the public sector and should be informed and defined through consultation with key stakeholders, including representatives of the public service workforce and service users.
- Public sector organisations should:
  - review all their significant current outsourcing contracts with a view to renegotiating and/or terminating where this is demonstrably in the public interest;
  - adopt a policy of all service provision being ‘in-house’ publicly managed by default and only to outsource where there is a demonstrably strong public interest for doing so;

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<sup>33</sup> *Written submission to PCAC Select Committee, SERCO, March 2018*

## Designing commissioning and procurement strategies that promote social, economic, employment and environment standards

In a mixed economy, where capacity, expertise and specialism may lie outside of the public sector, there may well be a public interest case for sourcing services from external providers. This could be particularly the case where charities and voluntary organisations are able to provide supplementary support to public bodies, helping to co-design and deliver services to meet specific needs or communities.

The corrosive effects of procurement models based on aggregation of services, price based competition, poorly designed attempts to manage risk through Payment by Results and a lack of acknowledgement of broader social, economic and environmental impacts are well documented.

From the introduction of Best Value procurement in the late 90s, through to the Public Services (Social Value) Act, public procurement legislation in Wales and Scotland and the latest iteration of the EC Procurement Directives through the Public Contracts Regulations 2015, there have been several attempts to reboot public procurement and move towards strategies that seek to enhance a broader a set of social value objectives. In 2017, the Crown Commercial Service published new guidance on placing social value at the heart of public procurement, requiring “buyers of public sector services to consider whether there are related social, economic or environmental benefits that can be delivered through the contract”.<sup>34</sup>

However, as research by Social Enterprise UK demonstrates, uptake is patchy and inconsistent. They found that only 24 per cent of local authorities have a social value policy, about a third of all councils routinely consider social value in their procurement and commissioning and that where councils score social value when scrutinising tenders, the score is typically between 5 and 10 per cent of the overall points awarded.<sup>35</sup>

Evidence also shows that outsourcing has a detrimental impact on pay, terms and conditions of the outsourced workforce. Analysis by the New Economics Foundation and Landman Economics for the TUC found that across six key metrics, including hours, pay, job tenure and qualifications, workers in the public sector had better standards than those performing the same jobs in the private or voluntary sector.<sup>36</sup> And the Times recently reported that outsourcing companies used by the government have worse gender pay gaps than the civil service. Of the 27 “strategic suppliers” paid tens of millions of pounds by the government each year, 18 have wider disparities than in civil servants' earnings.<sup>37</sup>

But there is good practice. Initiatives such as UNISON's ‘Ethical Care Charter’ and Children England and the TUC's ‘Declaration of Inter-dependence’ have provided ways of codifying

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<sup>34</sup> *Social Value Policy Statement*, CCS, April 2017

<sup>35</sup> *Procuring for good – how the Social Value Act is being used by local authorities*, Social Enterprise UK, 2016

<sup>36</sup> *Outsourcing Public Services*, TUC, 2015

<sup>37</sup> *Outsourcing companies have worse gender pay gap than civil service*, The Times, 9 April 2018

good social value practice through voluntary agreements that can be adopted by councils. Evidence shows that their application can have a positive impact on employment standards and value for money.<sup>38</sup>

Furthermore, governments in Wales and Scotland have used a combination of legislation and voluntary codes to push social value procurement more effectively than Westminster. The Code of Practice for Ethical Employment launched in March 2017, developed in partnership with unions and public service employers, places an expectation on all public sector organisations, businesses and third sector organisations in receipt of public sector funding to sign up to a code of practice that promotes decent jobs, a living wage and protects against blacklisting and other forms of exploitation. The Procurement Reform (Scotland) Act 2014 goes much further than the Public Contracts Regulations enforced in England and Wales, requiring all public bodies to have a procurement strategy in place that supports community benefits, the living wage and the economic, social and environmental well-being of the local area.

We would welcome a more dynamic approach from political leaders at a national and local level, including through combined authorities, to achieve a fundamental change in the way social value is promoted through public procurement in order to protect and promote decent employment standards and broader economic and social objectives, including spreading good practice from devolved administrations in Scotland and Wales.

Part of this should also include a set of expectations of the standards we would want to see from any organisation delivering outsourced public services. Sheila Drew Smith of the Committee for Standards in Public Life argues that the collapse of Carillion has shown how “an absence of ethical leadership, honest, transparency and accountability has cost the company, government and taxpayer and above all, its employees, subcontractors and those who rely on the public services it was contracted to provide”.<sup>39</sup>

In their 2014 report, the Committee calls for a more dynamic approach from the government to ensure that the seven Nolan principles of public life - honesty, integrity, accountability, selflessness, openness, leadership and transparency – apply to outsourced services. They contend that “the public care about “how” public services are delivered and want common ethical standards to apply regardless of provider type. This is an issue of trust, confidence and accountability. The public needs to be reassured that the standards it expects are clearly being articulated to providers of public services and being delivered by them.”<sup>40</sup>

The TUC would agree with the recommendations in their report, including the requirement to “ensure that ethical standards reflecting the Seven Principles of Public Life are addressed

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<sup>38</sup> *Evaluation of UNISON's ethical care charter*, University of Greenwich

<sup>39</sup> <https://cspl.blog.gov.uk/2018/02/01/the-collapse-of-carillion-a-failure-of-ethical-standards/>

<sup>40</sup> *Ethical standards for providers of public services*, Committee on Standards in Public Life, June 2014

in contractual arrangements, with providers required to undertake that they have the structures and arrangements in place to support this<sup>41</sup>

In order to provide increased security to the public and public sector commissioners alike, we also would support SERCO's suggestion that "suppliers of sensitive contracts should be obliged to lodge with government a 'living will', being a set of arrangements to facilitate the transfer of a contract back to Government or to another supplier if required"<sup>42</sup> and agree that this could significantly reduce the operational risk to government of supplier failure.

There are also grounds for better regulation of supply chains, ensuring that tier one contractors (and the contractors below them) are unable to contract out of their responsibility for maintaining decent employment standards throughout supply chains.

TUC research estimates that at least 5 million UK workers are unable to bring a claim against the organisations that they do work for, to enforce their basic workplace rights:

- 3.3 million are employed through outsourced companies;
- 615,000 are employed by franchise businesses;
- At least 1 million are employed by recruitment agencies, umbrella companies and personal service companies.

The TUC is calling for improvements in the enforcement system, which will make it impossible for organisations to shrug their shoulders and look the other way when the people who do work for them are not receiving their core workplace rights. More collective bargaining, joint and several liability and improvements in state led enforcement are necessary to restore accountability to the fragmented employment relationships that have developed as a result of outsourcing in the UK labour market.

The TUC believes there are many reasons for establishing a system of joint and several liability:

- organisations should take greater responsibility for the people that do work for them;
- it opens up multiple avenues for a worker to seek compensation;
- where a company goes insolvent, in phoenix cases or where the employer disappears, workers still have a course of action to enforce their rights;
- it would make contractors more diligent and careful in choosing their subcontractors;
- it would strongly incentivise the lead contractor to risk assess and tackle potential breaches of employment standards in their supply chains
- it incentivises the creation of more secure, permanent employment, as less contractors are willing to take the risk of working with subcontractors who might create liabilities for them.

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<sup>41</sup> *ibid*

<sup>42</sup> *Written submission to PCAC Select Committee, SERCO, March 2018*

## Policy Proposals

- The Cabinet Office, relevant government departments and Crown Commercial Service should pro-actively work with commissioners and decision makers across the public sector – including the health service and local government – to promote, implement and monitor a more dynamic approach to social value procurement, including best practice from devolved governments in Wales and Scotland.
- This should include the use of voluntary agreements and charters promoted by trade unions and others in order to promote high quality service, decent employment standards and protect against exploitation of the outsourced workforce and supply chain.
- All public service contractors should be required to meet the ‘Seven Principles of Public Life’ and have the structures and arrangements in place to support this.
- The government should extend joint and several liability laws so that workers can bring claims for employment abuses, such as claims for unpaid wages and holiday pay, against any contractor in the supply chain above them.

## Increasing transparency and accountability

Carillion was a major supplier to the public sector, with over 450 contracts across health, education, transport, criminal justice and local authorities, bringing in £2bn, 38 per cent of its total reported revenue in 2016. We also know that the company had a complex structure comprised of over 300 subsidiary companies.

This scale and complexity is replicated across a number of large private sector outsourcing companies.<sup>43</sup> Yet given the crucial role that these organisations play in the delivery of a vast range of core state functions, the lack of information on who runs what, for how long, at what cost and to what level of quality is alarmingly scarce.

According to the National Audit Office, the public sector spends more money on contracts than it spends on providing services itself. During 2014-15 it spent £242 billion (31 per cent of total government spending) on external suppliers, compared with £194 billion on staff costs.<sup>44</sup>

However, this figure includes good, services and construction. We can only estimate what proportion of this is spent on outsourced services as there is no systematic collation of data on outsourcing across the public sector.

In 2015, the TUC commissioned the New Economics Foundation to undertake research into the level of outsourcing in various government departments. Freedom of Information (FOI) requests were sent to thirteen government departments requesting details of expenditure on contractors for out-sourced public services. However, as there is no agreed definition of contracted-out services this was not expected to be especially fruitful. Only two

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<sup>43</sup> <https://blog.ouseful.info/2012/07/12/a-sketch-map-of-part-of-the-g4s-corporate-structure-and-a-light-shone-on-some-public-payments-to-them/>

<sup>44</sup> *Commercial and contract management: insights and emerging best practice*, NAO, November 2016

departments, the Department for Environment, Food & Rural Affairs (DEFRA) and Foreign & Commonwealth Office (FCO) had replied to the FOI requests by the time we were able to publish our findings, both explaining that their departments do not hold information regarding expenditure on contractors for out-sourced public services, and that it would incur undue expense to collect the data.

Neither the Cabinet Office nor the Treasury have reliable or complete data on contracts let in Whitehall, no consolidated data exists for the NHS, local government or the devolved administrations. The National Audit Office itself points out that there is too little information in the public domain to conduct an effective analysis of the performance, rewards and governance of major contractors delivering publicly funded services.<sup>45</sup>

This presents an accountability deficit - citizens and elected representatives should have easy access to information on who runs which parts of our public services. But it is also a barrier to intelligence on performance and quality that could be shared between public sector organisations, informing better commissioning decisions and driving innovation and joined up government.

We would therefore support the recommendation of Tizard and Walker in their report for the Smith Institute that "the government should compile a Domesday Book listing all significant contracts and create a central clearinghouse for evaluating the performance of companies across multiple contracts" – at least above a defined threshold of contract value.<sup>46</sup>

### **Policy Proposals**

The TUC recommends a number of measures to increase transparency and help support more accountability around outsourcing, including:

- Applying the Freedom of Information Act to all providers of public services.
- Requiring all providers of public services, within the public, voluntary and private sector to provide details of supply chains, company ownership and governance structures, employment, remuneration and tax policies and practices.
- Ensure all public sector organisations provide details of contracts or joint ventures except in cases of national security.
- Where services are outsourced, standardised accounting procedures and practices for 'open book' accounting should be enforced including an annual independent audit on all public service contracts.
- The government should compile a comprehensive list of all significant contracts across the public sector and create a central clearinghouse for evaluating the performance of companies across multiple contracts – this could take the form of a public services commission or an enhanced National Audit Office or a new regulator.

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<sup>45</sup> *The Role of Major Contractors in Delivering Public Services*, NAO, 2013

<sup>46</sup> *Out of contract*, John Tizard and David Walker, Smith Institute, January 2018



# Summary of Policy Proposals

## 1. Lessons for Workplace Rights

### Creating a culture where consultation is the norm

As the recent Review of modern working practices recognised,<sup>47</sup> there is a clear case for reforming ICE regulations. But the TUC and unions believe that the government should go beyond the limited proposals set out in the Taylor recommendations. In our opinion:

- The threshold for triggering information and consultation arrangements should be substantially reduced.
- Employers should be required to enter talks about the establishment of information and consultation arrangements if requested by a recognised trade union.
- In non-unionised workplaces, a request by five employees should be sufficient to trigger negotiations on ICE arrangements.
- The penalties for failure to establish ICE arrangements or to inform and consult should be substantially increased, in line with protective awards, payable in collective redundancies consultation cases. And courts should have the power to issue status quo orders preventing employers from acting or requiring them to reverse decisions, until meaningful consultation has taken place.

### Need for *early and meaningful* consultation on redundancies and outsourcing decisions

Action is needed to ensure that unions and workforces can participate in timely and meaningful consultation where there is a risk of mass redundancies or business closure. Proposals for reform include:

- Putting in place an early alert system to inform unions when strategic companies are at risk of insolvency. Early engagement with unions would provide the opportunities for unions, Ministers, the administrators and the companies to explore alternatives, including business rescues and the identification of new orders. It would also ensure that that staff get early access to support, training, redeployment.
- Ensuring that consultation with unions and workplace reps starts as soon as redundancies are being contemplated and reinstating the 90-day consultation period where 100+ jobs are at risk, to give unions and employers time to explore ways of avoiding redundancies.

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<sup>47</sup> <https://www.gov.uk/government/publications/good-work-the-taylor-review-of-modern-working-practices>

- Reviewing the role and duties of insolvency practitioners to ensure that the interests of working people are protected and that insolvency rules do not limit or deter insolvency practitioners from consulting the unions and workplace representatives.
- Exploring practices used in countries such as Austria, Belgium and Germany and Slovenia, where managers and unions are given time to agree social plans in redundancy and insolvency situations which protect the interests of working people. Whilst social plans are being discussed, companies should be protected from creditors.

### **TUPE protections in insolvency situations**

- Revise the 2006 regulations to make clear that full TUPE rights apply to all employees who are transferred to a new employer during an insolvency situation. These legal changes however would only benefit employees affected by future insolvencies.
- The Cabinet Office should agree to issue a Statement of Practice which confirms that all Carillion staff working on public sector contracts are entitled to full TUPE protections.

### **Missing out on pay protection**

The TUC believes that in the event of their employer's insolvency, all working people should be able to recover all forms of remuneration owed to them by their employer in full. This includes all unpaid wages, holiday pay, notice payments, maternity, paternity and parental leave pay and any outstanding sick pay. Employees should also be able to recover any protective awards owed to them due their employers' failure to consult on redundancies or TUPE transfers.

Such financial guarantees would not only ensure individuals receive what they are legally owed. More importantly, it would assist working people and their families to meet their housing, fuel and food bills whilst they look for new employment or seek training to help them find a new job.

We therefore call on the government to take urgent action to:

- Remove the current limits on the amounts which workers can recover from the Redundancy Payments Office.
- Ensure that all working people, including agency workers, those on zero hours contracts and the self-employed, can also recover unpaid wages etc from the Insolvency Service. Currently, the ability to apply to the Insolvency Service is limited to 'employees'.

## **2. Lessons for Corporate Governance**

### **The role of shareholders in the UK's corporate governance system**

The collapse of Carillion exposes the problems and risks of the reliance on the role of shareholders within the UK's corporate governance system. The TUC is calling for the following policy proposals to address shareholder primacy and the reliance on shareholder oversight:

- Reform directors' duties to make promoting the long-term success of the company the primary duty of directors. In addition, directors should be required to have regard to the interests of workers, shareholders, suppliers, communities and other stakeholders.
- Worker directors should comprise at least one third of the board of companies with more than 250 workers.
- Investors' corporate governance rights should be subject to a minimum period of share ownership of at least two years.
- Reform the mergers and takeovers system to ensure that it operates in the long-term interests of the target company (for more detail on this proposal, see Mergers and Takeovers - Proposals for Reform, TUC)
- Create a standing Corporate Governance Commission with stakeholder representation, tasked with keeping corporate governance policies and practice under review. As well as promoting high standards of corporate governance, the Corporate Governance Commission should have powers to hold directors to account for non-compliance with Section 172 and the other parts of directors' duties. It could potentially have a wider role in relation to enforcement, in particular in relation to areas where the inability or lack of inclination of shareholders to intervene leaves a gap in terms of the public interest.

### **Audit, accounting and reporting practices**

- Audit companies should not be permitted to engage in contracts for other business services with their clients.
- An inquiry into reporting, accounting and audit practices that contributed to the financial problems of Carillion being recognised for so long should be set up. Its scope should include the practice of booking profits before they are realised, a lack of focus on cashflow and debt within accounting and audit.
- The inquiry should aim to establish clear rules in relation to the practice of booking profits before they are realised.
- In addition, it should aim to produce proposals for reporting on debt and cashflow, with a particular focus on companies whose business model requires lumpy payments and revenue generation.
- Companies should be required to publish a pie chart showing how their revenues have been allocated, including dividends, R&D, executive remuneration and workforce pay.
- Companies should be required to publish a pie chart showing how their cashflow has been generated, including the use of debt.

### **Company structure and size**

- There should be further investigation, perhaps by the BEIS Parliamentary Committee, into the impact of corporate structures on corporate governance and transparency.

### 3. Lessons for public service outsourcing

#### ‘Make or buy’ – a public interest case

- The government should identify a set of “make or buy” public interest criteria that explains how the delivery mechanism chosen best promotes:
  - a public service ethos;
  - accountability to service users and elected representatives;
  - value for money in the round;
  - quality service standards;
  - long- term sustainability of the service;
  - high quality employment conditions and practice;
  - integration of services.
- These criteria should be applied to all significant commissioning decisions across the public sector and should be informed and defined through consultation with key stakeholders, including representatives of the public service workforce and service users.
- Public sector organisations should:
  - review all their significant current outsourcing contracts with a view to renegotiating and/or terminating where this is demonstrably in the public interest;
  - adopt a policy of all service provision being ‘in-house’ publicly managed by default and only to outsource where there is a demonstrably strong public interest for doing so;

#### **Designing commissioning and procurement strategies that promote social, economic, employment and environment standards**

- The Cabinet Office, relevant government departments and Crown Commercial Service should pro-actively work with commissioners and decision makers across the public sector – including the health service and local government – to promote, implement and monitor a more dynamic approach to social value procurement, including best practice from devolved governments in Wales and Scotland.
- This should include the use of voluntary agreements and charters promoted by trade unions and others in order to promote high quality service, decent employment standards and protect against exploitation of the outsourced workforce and supply chain.
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- The government should extend joint and several liability laws so that workers can bring claims for employment abuses, such as claims for unpaid wages and holiday pay, against any contractor in the supply chain above them.

### **Increasing transparency and accountability**

The TUC recommends a number of measures to increase transparency and help support more accountability around outsourcing, including:

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- Ensure all public sector organisations provide details of contracts or joint ventures except in cases of national security.
- Where services are outsourced, standardised accounting procedures and practices for 'open book' accounting should be enforced including an annual independent audit on all public service contracts.
- The government should compile a comprehensive list of all significant contracts across the public sector and create a central clearinghouse for evaluating the performance of companies across multiple contracts – this could take the form of a public services commission or an enhanced National Audit Office or a new regulator.