# THE APPLICATION OF SECTION 197 OF THE LABOUR RELATIONS ACT IN AN OUTSOURCING CONTEXT (PART 2)

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**SUMMARY**

Section 197 of the Labour Relations Act (LRA) in both its original form and in its amended form caused much confusion and debate. An analysis of the amended section 197 was conducted by considering the interpretation and application of the courts as well as various authors' views. This analysis attempted to clarify the impact of section 197 on transfers of businesses as going concerns. An analysis of the application of section 197 to outsourcing arrangements then followed. It showed that a distinction between first- and second-generation outsourcing is paramount to determining whether or not section 197 is applicable to outsourcing arrangements. Case law has not provided certainty in this area as the various courts have held opposing views with regard to whether a literal or purposive approach should be adopted. All the implications (whether positive or negative) should be rigorously considered by the courts to clarify the true application of section 197 in an outsourcing context.

## 1 INTRODUCTION

> "It is generally accepted that section 197[1] [of the Labour Relations Act[2] (LRA)] does apply to a situation where company A, which all along has been employing workers to perform certain work, ceases to have that work performed by its workers and contracts with another company, company B, to do that work for it and effectively transfers that business or part of its business to B as a going concern."[3]

The above is a typical example of an outsourcing arrangement.

Section 197 requires that, unless otherwise agreed, the transferee employer ("the new employer") be substituted for the transferor ("the old

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1 S 197 Transfer of contract of employment.

2 Act 66 of 1995.

3 *Aviation Union of South Africa v South African Airways (Pty) Ltd* (not yet reported) 2009-11-10 Case number JA 51/07 [9].

employer") as the employer of all employees engaged in the business being transferred. In other words, except for the change in identity of the employer party, the contracts of employment in place at the time of the transfer remain unaffected and any term of the contract between an employee and the old employer can be enforced, after the transfer, against the new employer.[4]

Section 197 raises some difficulties especially relating to the following:

- When does a transfer of a business as a going concern take place;
- what constitutes a "business"; and
- when is an entity part of a business, trade, undertaking or service?

A more glaring controversy relates to whether section 197 applies to "second-generation contracting out or outsourcing".[5] [6]

Since 2002 some courts[7] are of the view that section 197 applies to second-generation outsourcing, implying that when the outsourcing contract changes hands from one contractor to another (for example from company B to company C), section 197 would apply, and employees concerned would transfer automatically. The implications of such an interpretation could have vast consequences.

Other courts[8] have found that section 197 only contemplates first-generation outsourcing; in other words, the situation where the business is transferred by the old employer (Company A) to the new employer (Company B), and not second-generation transfers (Company B to Company C).

These conflicting views flow from the interpretation and application of section 197.[9] Some authors, such as Bosch,[10] are of the view that section 197 should be widely interpreted; thus, the proper protection of employee rights may require the courts to construe section 197 more widely than narrowly (the purposive approach). Other authors, such as Wallis,[11] are of the opinion that section 197 should be confined to the transfer of businesses and to that subject alone (the literal approach).

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4 Van Niekerk, Christianson, McGregor, Smit and Van Eck *Law@work* (2008) 300.

5 *Eg*, as explained by Laubscher "Employment Law Update: Section 197" December 2005 *De Rebus* 49 "where there is an initial outsourcing from one employer (A) to a contractor (B) and after some time, the contract with B is cancelled and awarded to another contractor (C)".

6 Bosch "*Aluta Continua*, or Closing the Generation Gap: Section 197 of the LRA and Its Application to Outsourcing" 2007 *Obiter* 84.

7 See amongst others *SAMWU v Rand Airport Management Company (Pty) Ltd* [2002] 12 BLLR 1220 (LC); and *COSAWU v Zikhethele Trade (Pty) Ltd* [2005] 9 BLLR 924 (LC).

8 See amongst others *Crossroads Distribution (Pty) Ltd t/a Jowells Transport v Clover SA (Pty) Ltd* [2008] 6 BLLR 565 (LC); and *Aviation Union of South Africa v SAA (Pty) Ltd* [2008] 1 BLLR 20 (LC).

9 In terms of s 1 of the LRA all provisions of the LRA should be interpreted in the context to advance economic development, social justice, labour peace and democratisation of the workplace. S 3 of the LRA provides that "any person applying this Act must interpret its provisions: (a) to give effect to its primary objects; (b) in compliance with the Constitution; (c) in compliance with the public international law obligations of the Republic".

10 Bosch 2007 *Obiter* 84; and Bosch "Of Business Parts and Human Stock: Some Reflections on Section 197(1)(a) of the Labour Relations Act" 2004 *ILJ* 1865.

11 "Is Outsourcing In? An Ongoing Concern" 2006 *ILJ* 1.

This article will briefly analyse section 197 and particularly the meaning of the various concepts within section 197 such as "going concern", "business, trade, undertaking, or service", and "transfer" as well as relevant case law relating to these concepts.

The difference between first-generation outsourcing and second-generation outsourcing will be discussed with reference to related case law. The confusion created by the myriad of case law regarding the question whether section 197 applies to "second-generation outsourcing or contracting out" will be investigated. The article will attempt to answer the question whether section 197 applies to "second-generation outsourcing or contracting out" or not.

## 2 THE "NEW" SECTION 197

### 2 1 An analysis of the new section 197

There was a substantial amendment in 2002 to the law relating to the position of workers whose employers transfer their businesses.[12] The amended section sets out more clearly what the consequences are should the section be found to apply.[13]

Section 197 of the LRA was substituted by section 49 of the Labour Relations Amendment Act[14] and section 197(1) now reads as follows:

> "In this section and in section 197A-
> (a) **'business'** includes the whole or a part of any business, trade, undertaking or service; and
> (b) **'transfer'** means the transfer of a business by one employer ('the old employer') to another employer ('the new employer') as a going concern."

Section 197(2)(a) reads:

> "If a transfer of a business takes place, unless otherwise agreed in terms of subsection (6) –
> (a) the new employer is automatically substituted in the place of the old employer in respect of all contracts of employment in existence immediately before the date of transfer."

The effect of these provisions is that the old employer is not required to seek the employees' consent before their contracts are transferred; neither does the old employer have to retrench them. The employment contracts migrate automatically and no dismissals are deemed to have occurred.[15]

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12 Grogan and Gauntlett "The New Law on Retrenchment – Practical Effects of the Amendments to Section 189 and 197" August 2002 *EL* 4.

13 Bosch "A Survey of the 2002 Labour Legislation Amendments: Is There Really 'Something for Everyone'?" 2003 *ILJ* 23 48.

14 12 of 2002.

15 Du Plessis and Fouché *A Practical Guide to Labour Law* 6ed (2006) 283.

The amendment clearly sets out that, when businesses are transferred as going concerns, affected employees retain their jobs with the new employer irrespective of the wishes of the employers.[16]

The right of employees to have their contracts transferred is dependent on the transfer of a business meeting the exact wording of section 197, namely if "the whole or part of a business, trade, undertaking or service" is transferred by the old employer "as a going concern".[17]

For a transaction to fall within the scope of section 197, three elements must simultaneously be present. These are:

- a transfer by one employer to another;
- the transferred entity must be the whole or part of a business (or, is there an economic entity capable of being transferred?); and
- the business must be transferred as a going concern (or does the economic entity that is transferred retain its identity after the transfer?).[18]

These phrases are crucial, because if the entity transferred is not a business or part thereof, or if it is not transferred "as a going concern", the main consequences of section 197, namely, the transfer of the contracts of employment of the old employer to the new employer, do not occur by operation of law.[19]

## *2 1 1 "Going concern"*

The statutory definitions do not clarify the concept of a "going concern" and it has been left to the courts to determine the circumstances in which it can be said that, for the purposes of section 197, a business has been transferred as a "going concern". The Labour Court (LC) has held that the tests applied to determine whether or not a business is transferred as a "going concern" for other purposes, such as the obligations to pay VAT, are of no consequence.[20]

So what is a transfer of a business as a "going concern"? A transfer as a "going concern" is effected when the economic entity that comprises the business retains its identity after the transfer. Typically, the identity of the entity that comprises a business, trade, undertaking or service comprises the employees themselves, the premises on which it is conducted, fixtures and fittings, stock, work-in-progress, contracts, book debts, brand names, trademarks and patents as well as intangible assets such as goodwill.[21]

The Constitutional Court (CC) in the *NEHAWU v University of Cape Town*[22] held that the test is an objective test (thus not dependent on the

16 Grogan and Gauntlett "Going Concerns" February 2003 *EL* 20.
17 Basson, Christianson, Garbers, Le Roux, Mischke and Strydom *Essential Labour Law* 5ed (2005) 174.
18 Van Niekerk *et al* 302.
19 Grogan *Dismissal, Discrimination & Unfair Labour Practices* (2005) 410.
20 Van Niekerk *et al* 305.
21 Van Niekerk *et al* 306.
22 2003 3 SA 1 (CC).

desires of the parties involved in the transfer) and one which has regard to substance and not form. The question is whether there is the transfer of a business in operation "so that the business remains the same, but in different hands".[23]

What is critical is whether the new employer continues or resumes the old employer's operations, with the same or similar activities. In other words, the degree to which the transferred business preserves a distinct and separate identity that continues or resumes the operation of the activity concerned, is crucial in a determination of whether a transfer has taken place for the purposes of section 197.[24]

The Labour Appeal Court (LAC) in *NEHAWU v University of Cape Town*,[25] recited the ordinary definitions of a going concern: one in actual operation; a business already in operation (which cannot occur in the absence of the workforce) or an existing business operating in its ordinary and regular manner. A going concern can only arise where all or a material part of the workforce is included.

> "To say that there can be a sale of a business as a going concern without all or most of the employees going over is to equate a bleached skeleton with a vibrant horse."[26]

Determining whether a transfer of a business amounts to a transfer as a "going concern" is in short an issue that must be decided on the facts of each case.[27]

### *2 1 2 "Business, trade, undertaking or service"*

Grogan is of the view that the definition of "business" in section 197(1)(a) is tautological; its main purpose seems to be to emphasise that section 197 applies not only to the transfer of entire businesses, but also to parts of businesses.[28]

Section 197 will only apply when what is transferred is a "business".[29] In terms of section 197(1)(a) a "business" includes the "whole or a part of any business, trade, undertaking or service".

What does the concept "business" relate to? It is clear that in the modern-day sense of the word a "business" would comprise not only tangible and intangible assets, but also intellectual property assets.[30]

It is relatively easy to determine when the whole of a business, trade, undertaking or service is transferred, but problems arise in determining what

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23 Bosch 2004 *ILJ* 1865.
24 Van Niekerk *et al* 308.
25 [2002] 4 BLLR 311 (LAC).
26 *NEHAWU v University of Cape Town supra* par 104.
27 Grogan "A Twist on Transfers: LAC Reinterprets Section 197" June 2002 *EL* 9 12-13.
28 Grogan 410.
29 Bosch 2004 *ILJ* 1866.
30 Olivier and Smit "Transfer of a Business, Trade or Undertaking" September 1999 *De Rebus* 83.

is a part of a business, trade, undertaking or service for the purposes of the application of section 197.[31]

Grogan points out that at a semantic level, the term "business" includes "the whole or a part of any business, trade, undertaking or service". Why the legislature thought it necessary to include the words "trade" and "undertaking" is not altogether clear. Both are in their ordinary meaning in any event "businesses" – in their context, "businesses", "trades", and "undertakings" are all broadly speaking synonymous. If the word "service" is read in the light of the preceding words, it may refer to the kind of business that renders a service to its clients, customers, or community; and that concept would not include a division within the larger business, like gardening or security, even if they also render services to the corporate goal.[32]

Bosch advocates that, "the correct approach to determining whether section 197 will apply to a particular situation is to examine what the transferor is to be divested of as a result of the transfer and assess whether that can properly be considered a "business". That entity will then be compared with what ends up in the hands of the transferee in order to establish whether the "business" has been transferred as a "going concern", that is whether it is substantially the same business but in different hands."[33]

Du Toit *et al* submit that the test in respect of a "service" or "part of a service", as in the case of a "business" or "part of a business" other than a "service", is whether the activity being transferred amounts to "an organized grouping of resources which has the objective of pursuing an economic activity".[34]

What is clear though, is that a business entity cannot be said to consist solely of the activity being performed by it. A court ought to examine all the relevant elements and components that comprise the "business", and determine whether they are sufficiently linked and structured so as to comprise an economic entity capable of being transferred in terms of section 197.[35]

### *2 1 3 "Transfer"*

A "transfer" is defined in section 197(1)(b) to mean the transfer of a business by one employer ("the old employer") to another employer ("the new employer"). This definition sheds the light on which kinds of transfers potentially fall within the ambit of section 197. Two distinct enquiries should occur. First, was there a transfer within the meaning of section 197? If so, on the facts, was there a transfer of an undertaking as a going concern? The

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31 Bosch 2004 *ILJ* 1866.

32 Grogan 411 and 412.

33 Bosch 2004 *ILJ* 1868.

34 Du Toit, Bosch, Woolfrey, Godfrey, Cooper, Giles, Bosch and Rossouw *Labour Relations Law: A Comprehensive Guide* 5ed (2006) 452.

35 Van Niekerk *et al* 305.

concept of a "transfer" thus relates to the method of the "transfer" of a business.[36]

Business transfers occur as a result of a sale of the business, but the reach of section 197 clearly extends beyond transfer effected in these circumstances.[37]

In *Schutte v Powerplus Performance (Pty) Ltd*[38] the LC accepted that "transfer" of a business refers only to sale but may include "merger, take-over or … part of a broader process of restructuring within a company or group of companies. Transfer can take place by virtue of an exchange of assets or a donation".[39]

The more important question is: when has a "transfer" as a going concern occurred? The LC in *Ndima v Waverley Blankets Ltd*[40] made the following points:

- There is a distinction between the transfer to a business as a going concern and the physical transfer of assets. In the former case the business remains the same business but in different hands. In the latter case the assets are transferred to the new owner to be used in whatever business he may choose;
- the transfer of a business and the transfer of possession and control of a business are different concepts; and
- whilst in reality the sale of shares in a company is used not only to gain control but also in effect the business itself, the purchase of shares in a company does not necessarily mean the buyer is going to continue the same business.

The mere transfer of administrative functions would probably not constitute a transfer for purposes of section 197, as business-like activities are not involved.[41]

The "transfer" of a business as a going concern may include the increasingly common practice of "outsourcing" or "contracting-out" various services which previously formed part of the business.[42]

### *2 1 4 Factors in favour of the transfer as a going concern*

As the CC in *NEHAWU v University of Cape Town* [43] has emphasised, an overall assessment of the situation is necessary and no single factor is definitive in itself.[44]

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36 Van Niekerk *et al* 302-303.
37 Van Niekerk *et al* 303.
38 [1999] 2 BLLR 169 (LC).
39 Du Toit *et al* 448.
40 [1999] 6 BLLR 577 (LC).
41 Olivier and Smit September 1999 *De Rebus* 83.
42 Du Toit "Other Basic Rights Relevant to Labour: Socio-economic Rights" 2004 *Bill of Rights Compendium* 4B35.
43 *NEHAWU v University of Cape Town* 2003 24 *ILJ* 95 (CC) 119F-120A.
44 Van Niekerk *et al* 308.

Factors to be considered in the assessment include:[45]

- The type of undertaking, business, trade or service;
- the fact that its operation was actually continued or resumed by the new employer, with the same or similar activity;
- whether or not tangible assets, such as buildings and movable property, are transferred;
- the value of its intangible assets at the time of the transfer;
- whether or not the majority of its employees are taken over by the new employer;
- whether or not its customers are transferred;
- the degree of similarity between the activities carried on before and after the transfer; and
- the period, if any, for which those activities were suspended.

The LAC in *NEHAWU v University of Cape Town*[46] held that apart from the fate of the workforce of the transferor, other relevant considerations are: what happens to the goodwill of the business, stock-in-trade, premises, existing contracts, assets and debts, and whether the same or similar activities are continued after the transfer.[47]

The CC in *NEHAWU v University of Cape Town*[48] (as *obiter*) suggested that the following will be relevant:

- Whether assets, tangible or intangible, have been transferred;
- whether or not workers are taken over;
- whether customers are transferred; and
- whether or not the same business will be conducted by the buyer or new employer?

This is not a closed list and no single factor is supposedly decisive. What a court is required to do is to examine the entity being transferred prior to transfer and then assess it after the transfer to ascertain whether it remains the same business, but in different hands.[49]

According to Bosch, the results of the application of the test for transfer of a going concern depend on the circumstances of the particular case, but there is no reason why the test cannot be applied consistently whether to business sales, or initial or subsequent outsourcing.[50]

What is clear from the above discussion is that a court will have to examine all the relevant elements and components that comprise the "whole or part of a business, trade, undertaking or service", and determine on the

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45 Van Niekerk *et al* 307.
46 [2002] 4 BLLR 311 (LAC).
47 Grogan June 2002 *EL* 12.
48 2003 24 *ILJ* 95 (CC).
49 Bosch 2004 *ILJ* 1866.
50 Bosch 2007 *Obiter* 94.

facts of each case whether there has been a transfer as a "going concern" in terms of section 197.

## 2 2 Case law relating to the new section 197

### *2 2 1 NUMSA v Staman Automatic CC:[51] LC decision*

The second opportunity for the LC to express itself on what is a "part" of a business for the purposes of section 197 arose in this matter.[52]

The LC noted that the amended section 197 defines "business" as "the whole or part of any business, trade, undertaking, or service". Whether the transfer of a number of employees could constitute a transfer of business was the critical issue.[53]

The LC found that there was no "service" that could be transferred in terms of section 197.[54] It does not follow that a group of employees who render services to an employer constitute an economic entity capable of being transferred within the meaning of section 197.[55]

The LC's approach was to examine what was to be transferred and assess whether that amounted to a "business". *In casu*, the employees purported to be engaged in the transfer of part of the transferor's business, whereas in reality all that was being transferred was the transferor's employees or, more specifically, their services. Those could not on their own constitute part of a business for the purposes of section 197.[56]

### *2 2 2 SAMWU v Rand Airport Management Company (Pty) Ltd:[57] LC decision*

The addition of the word "service" was first considered by the LC in this matter. According to Landman J, the addition of the word "service" to the definition of "business" did not alter the reach of section 197 significantly. A service can be described as a part of a business only if it is "an identifiable component or unit of a business, be it a division, a branch, a department, a store or a production unit"; it must be "severable from the entire business" before it can be regarded as part of that business for purposes of section 197.[58]

The purpose of the addition of the word "service", was, in Landman J's view, to clarify "the position that a business, to use a general term, may

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51 [2003] 11 BLLR 1167 (LC).
52 Bosch 2004 *ILJ* 1867.
53 Grogan and Gauntlett "Case Roundup: Not Transfers" December 2003 *EL* 20.
54 Bosch 2004 *ILJ* 1868.
55 Grogan and Gauntlett December 2003 *EL* 20.
56 Bosch 2004 *ILJ* 1868.
57 [2005] 3 BLLR 241 (LAC).
58 *SAMWU v Rand Airport Management Company (Pty) Ltd supra* par 19.

consist mainly or only of the rendering of services to another or other persons for profit or otherwise".[59]

The LC admitted to having

> "some difficulty in conceiving that a support function, as necessary as it may be, ordinarily constitutes a business or part of a business. This is not to say that the door is closed, merely that, read with the concept of a going concern, it may be more difficult to find this to be so. But each case must be evaluated on its own merits".[60]

### *2 2 3 SAMWU v Rand Airport Management Company (Pty) Ltd:[61] the LAC decision*

The LAC attached great significance to the addition of the word "service" to the definition of "business".[62] In its ordinary meaning the word means "the provision of a facility to meet the needs or for the use of a person or a person's interest or advantage".[63]

The LAC ruled that a contract to outsource gardening functions is a service within the meaning of section 197. The contractor therefore will automatically inherit the people engaged in this function on their existing terms and conditions of employment. This judgment reverses the LC decision,[64] where it was found that the outsourcing of the gardening function fell outside of section 197.

The LAC missed an opportunity to deal properly with the issue of outsourcing and section 197. It noted that this section had been amended to include a "service", took the ordinary grammatical meaning of the word (which is wide in itself) and found that the contractual obligations of the contractor fell within this definition. Therefore section 197 applied.[65]

The lesson to be derived from the *Rand Airport (LAC)* judgment is that outsourcing may in some cases constitute the transfer of a business that attracts the provisions of section 197, and possibly section 187(1)(g)[66] of the LRA. The judgment also confirms that whether a particular outsourcing arrangement constitutes such a transfer depends on the facts.[67]

Unfortunately the LAC did not spell out in detail why it reached the conclusion that these particular outsourcing arrangements constituted transfers of services as going concerns, nor did it explain why the LC's conclusions were wrong. According to Grogan, the LAC's reasoning appears to be that, once it is accepted that a unit of an employer's organisation

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59 *Ibid*.
60 *SAMWU v Rand Airport Management Company (Pty) Ltd supra* par 24.
61 [2005] 3 BLLR 241 (LAC).
62 Grogan "Outsourcing Services" April 2005 *EL* 6.
63 *SAMWU v Rand Airport Management Company (Pty) Ltd supra* par 17.
64 See par 2 2 2 above.
65 *Ibid*.
66 S187. Automatically unfair dismissals (1) A dismissal is automatically unfair if the employer, in dismissing the employee, acts contrary to section 5 or, if the reason for the dismissal is – (g) a transfer, or a reason related to a transfer, contemplated in section 197 or 197A.
67 Grogan April 2005 *EL* 11.

performs certain functions for the employer, any arrangement in terms of which those functions will be performed by another entity will constitute a transfer of part of that employer's business, and thus trigger the consequences spelled out in section 197.[68]

## 3 OUTSOURCING

The application of section 197 has been most controversial in transactions in which businesses, or parts of business, are outsourced.[69] In *NEHAWU v University of Cape Town*,[70] the LC described outsourcing as:

> [T]he putting out to tender of certain services for a fee. The contractor performs the outsourced services and in return is paid a fee for its troubles by the employer … An outsourcing transaction is usually for a fixed period of time at the end of which it again goes out to tender and the existing contractor could lose the contract to another contractor.[71]

Outsourcing is the process in terms of which an enterprise unbundles itself by contracting with other entities to perform some of the tasks previously performed by its own employees. In its usual form, outsourcing is a temporary arrangement: the outsourcer concludes a contract with the service provider for a specific period, and reserves the right to renew the contract at the end of the period, or not to renew it. This means that depending on how the contractor performs, the outsourcer may decide to perform the outsourced functions again itself, or award the contract to another.[72]

Outsourcing in this basic form is no longer referred to as outsourcing or contracting-out, it is now referred to as first-generation outsourcing.[73]

In a case of outsourcing, the contractor retains the right to terminate the contract and to perform the services again itself, if it so wishes, when the contract expires.[74]

What, if any, are the rights of workers when their employer decides to outsource their work to a contractor? The question is likely to become increasingly important as employers in the private and public sector latch on to the idea that it might be more efficient and cost-effective to concentrate on their "core business" and to leave support services to be rendered by outsiders who are usually cheaper and possibly better at such work.[75]

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68 Grogan April 2005 *EL* 12.
69 Van Niekerk *et al* 308.
70 [2000] 7 BLLR 803 (LC).
71 [2000] 7 BLLR 803 (LC) 816.
72 Grogan and Gauntlett "Second-generation Outsourcing" October 2005 *EL* 10.
73 Wallis 2006 *ILJ* 2.
74 Grogan and Gauntlett "Case Roundup: Transfer of business" August 2000 *EL* 26.
75 Grogan and Gauntlett "Outsourcing Workers: A Fresh Look at Section 197" October 2000 *EL* 15.

## 3 1 Can outsourcing be a transfer in terms of section 197?

Section 197 does not deal directly with the question of whether outsourcing or contracting-out of services can be a "transfer" for the purposes of section 197.[76] Do employees whose functions are outsourced transfer automatically to the sub-contractor?[77]

Outsourcing presents two problems: the first is that the sub-contractor may not want to take on any or some of the workers who have been providing the service concerned, which leaves the employer with the problem of retrenching them; which then gives rise to the second problem, may the employer do so, or is the sub-contractor bound to employ the workers for purposes of the contract?[78]

If outsourcing does not constitute a transfer of a business as a going concern, workers affected by outsourcing do not automatically transfer to the sub-contractor if the sub-contractor does not want them. If outsourcing does constitute a transfer of a business as a going concern, the workers do automatically transfer.[79]

Bosch is of the view that the fact that a "business" is defined in section 197 as "the whole or a part of any business, trade or undertaking or **service**" could be taken as an indication from the legislature that the section should apply to outsourcing.[80]

However, Wallis advocates that "an inference cannot be drawn from the inclusion of "service" in the definition of business, that there was an intention to bring within the operative portion of section 197 a contract for the provision of services. It is never in question in first-generation outsourcing that at least one and usually both parties are a "business, trade or undertaking" and that also holds true for second-generation outsourcing."[81]

## 3 2 "First- v Second-generation outsourcing"

Second-generation outsourcing occurs when a new contractor replaces the incumbent contractor. This typically occurs when the terms on which the service provided by a contractor are reviewed or put out to tender, and another service provider, often a competitor of the incumbent contractor, is appointed to provide the service.[82]

For example, there is an initial outsourcing from one employer (A) to a contractor (B) and after some time, the contract with B is cancelled and awarded to another contractor (C). Is C obliged to take over the employees of B who performed the functions in terms of the contract; thus is there a

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76 Bosch 2003 *ILJ* 48 and 49.
77 Grogan April 2005 *EL* 3.
78 *Ibid.*
79 Grogan April 2005 *EL* 4.
80 Bosch 2003 *ILJ* 49.
81 Wallis 2006 *ILJ* 9.
82 Van Niekerk *et al* 309.

transfer as a going concern between B and C because the contract is awarded to C?[83]

The question left undecided in *Rand Airport (LAC)* was: what happens to the contractor's employees if the contract is awarded to another contractor?[84] This question was raised by the LC in *NEHAWU v University of Cape Town*:

> "If outsourcing is a transfer of a business in terms of [the original] section 197, I do not see how the contractor who loses the contract can transfer its employees to the successful contractor as it has no say in who gets the contract. That, say, remains vested in the outsourcing party. Conversely, I do not see how the outsourcing party can force the successful contractor to take over the employees of the outgoing contractor. This scenario illustrates the difficulties regarding outsourcing as a transfer of a business."[85]

If, however, the substitution of a new contractor constitutes a transfer of business as a going concern from the old contractor, it would be impossible for any other contractor to bid for the contract, unless it is prepared to take over the old contractor's staff. As far as Grogan is concerned, "that could sound the death knell of outsourcing contracts as we know them".[86]

In the European Union first-generation and second-generation outsourcing arrangements are treated differently. In the event of first-generation outsourcing, several factors are considered and the decisive criterion seems to be the actual continuance of the same or similar activities by the new contractor. In second-generation transfer, however, additional requirements are set before finding that a relevant transfer occurred. These relate to the transfer of some tangilble or intanglible assets and the transfer of a major part of the staff (in terms of numbers and skills).[87]

According to Wallis, the term first-generation is only relevant if there is a second to follow it and second-generation is nothing of the sort. Second-generation outsourcing does not arise from one party ceasing to undertake certain work itself through its own employees and deciding to contract with a third party for the performance of that work on its behalf.[88]

Wallis feels that the expression "second-generation outsourcing or contracting-out" is catchy but an inaccurate way of describing a situation where there is no need for the first party ever to have undertaken the work itself. It describes nothing more than a decision by a party to change its supplier, that is, where the principal has contracted with another to perform certain work or provide certain services and for any variety of reasons, the principal decides to change contractor.[89]

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83 Laubscher December 2005 *De Rebus* 49.
84 Grogan and Gauntlett October 2005 *EL* 10.
85 *NEHAWU v University of Cape Town supra* 32.
86 Grogan April 2005 *EL* 12.
87 Van Niekerk *et al* 309.
88 Wallis 2006 *ILJ* 2.
89 *Ibid*.

Wallis's view is that

> "merely because there may have been some prior outsourcing decision by the principal does not make the change of contractor into an outsourcing of any generation. Precisely the same issues arise even if the principal never at any stage undertook the relevant work through the medium of its own employees. A change in auditors, cleaners, security guards or any other form of supplier of goods and services is legally and economically the same thing, whether or not the work was previously done 'in house'. There is no justification for describing this as an 'outsourcing' or 'contracting-out' of any generation … Telling the farmer or the cold storage contractor or the dietician that all fruit is the same fruit albeit of different generations is a recipe for disaster, not to say some rather quaintly composed fruit salads."[90]

Looking at the example of the changing of auditors, the effect will be that when auditors are changed at an organisation, the auditors from firm A will automatically transfer to firm B and will continue to do the audit, thereby defeating the very purpose of changing auditors.[91]

The position is complicated further by including "contracting-in" or "third-generation outsourcing" under the explanation as second-generation. "Contracting-in" or "third generation outsourcing" refers to the decision by a principal to terminate a contract for the provision of work or services and to use its own employees or employ people itself to undertake the work.[92]

## 3 3 Case law relating to second-generation outsourcing

### *3 3 1 COSAWU v Zikhethele Trade (Pty) Ltd*:[93] *the LC decision*

Prior to this judgment it had been argued that section 197 could not apply to second-generation outsourcing because the section speaks of a transfer of a business *by* the old employer. The argument is that in the second-generation scenario, the transfer is by the client to whom the service is being rendered and not the old employer, that is, the outgoing contractor.[94]

The LC noted that it was in new territory. It was certainly arguable that the cancellation of an initial outsourcing contract and its transfer to a second bidder does not attract the provisions of section 197. On the other hand, a contractual link between the transferor and the transferee is not a necessary precondition for the application of section 197.[95]

The LC resolved the issue with a purposive interpretation of section 197. Employees affected by a "second-generation" outsourcing contract are as deserving of protection as those affected by the first.[96]

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90 Wallis 2006 *ILJ* 2 and 3.
91 Wallis 2006 *ILJ* 3.
92 Wallis 2006 *ILJ* 4.
93 [2005] 9 BLLR 924 (LC).
94 Bosch 2007 *Obiter* 86; and *COSAWU v Zikhethele Trade (Pty) Ltd supra* par 27.
95 Grogan and Gauntlett "Case Roundup: Double Transfer" August 2005 *EL* 20.
96 *Ibid*.

The LC held that section 197(1)(b) must accordingly be interpreted to include within its scope transfers of business *from* one employer to another, not only to transfers *by* the old employer.[97] Furthermore, a second-generation transfer can be viewed as a process in terms of which the business is handed back to the old employer by the first contractor, and in which the employer then transfers the business to the new contractor.[98]

Such a pragmatic interpretation, the LC held, would allow a finding

> "that a business in actual fact can be transferred by the old employer in such circumstances, but that the transfer occurs in two phases: in the first, the business is handed back to the outsourcer and in the second it is awarded to the new employer."[99]

### *3 3 2 The two-phase transfer adopted by the LC in Zikhethele*

Murphy AJ explained that such a transfer takes place in two phases, namely the business is first handed back to the initial owner (A) and then transferred anew to the successful tenderer (C).[100]

If the cancellation of the first outsourcing arrangements results in a temporary reversion of the business to the outsourcer before its transfer to the new contractor, the transfer is still effected by the old employer.[101]

This "two-phase" interpretation has been the subject of much criticism. It has been suggested that all that transpires when a second-generation contract is concluded is the termination of one commercial contract and the commencement of a new contract, in other words that neither in fact nor in law is there any reversion to the client (the initial owner (A)).[102]

The two-phase approach of the LC in *Zikhethele* resulted in the LAC finding that the client/initial owner (A) should have been joined in the proceedings.[103]

### *3 3 3 Was Zikhethele correct?*

Grogan is of the view that the court could probably have concluded that the business had transferred as a going concern without resorting to the "two phase" approach or amending the plain language of section 197(1)(b), because the court had concluded that "the business as a going concern had retained its identity to a sufficient degree to constitute a transfer of business".[104]

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97 Grogan and Gauntlett August 2005 *EL* 20; and *COSAWU v Zikhethele Trade (Pty) Ltd supra* 29.

98 Grogan and Gauntlett August 2005 *EL* 20.

99 *COSAWU v Zikhethele Trade (Pty) Ltd supra* 29.

100 Laubscher December 2005 *De Rebus* 49.

101 Grogan and Gauntlett October 2005 *EL* 13.

102 Van Niekerk *et al* 311.

103 *Zikhethele Trade (Pty) Ltd v COSAWU obo members* [2008] 2 BLR 163 (LAC) par 24.

104 Grogan and Gauntlett October 2005 *EL* 14.

According to Bosch, it was unnecessary to find that the transfer occurred in two phases because of the interpretation of section 197 adopted by the LC. If one accepts that section 197 applies to transfer *from* one employer to another, how the transfer occurred is insignificant. All that is important is that the entity that is transferred is a "business" and that it is transferred from the old employer to the new employer as a going concern.[105]

Van Niekerk *et al* are of the view that section 197(1)(b) refers to a transfer *by* one employer to another employer. To read this provision to mean (as the court did in *Zikhethele*) that section 197 applies when there is a transfer *from* one employer to another is not sustainable given the plain meaning of the words. If the application of section 197 is so limited, the section will affect "first-generation" outsourcing (since there is invariably a transfer of part of a business from one employer to another) but second and subsequent transfers will not.[106]

Wallis states that "transfer" contemplates only two positive actors in the process, namely the old employer and the new employer, and no-one else. There must be an identifiable business, which includes a part of a business, and that must be the subject of the transfer *by* the old employer to the new employer. The current section 197 says that the old employer is a positive actor in the process. This is not what occurs when an institution has concluded a contract for the provision of cleaning services and at the expiry of the contract puts it out for tender and the existing contractor loses the tender. Here the role and function of the old employer is to strive to keep the contract, not to transfer all or any part of its business to someone else and when it does not succeed in being awarded the tender, it does not extend a hand of congratulations to the winner and promise it every support.[107]

Wallis's view is that there is simply no excuse for changing the words that the legislature after careful consideration and much debate put there.[108]

> "No dictionary that I have consulted equates '**by**' with '**from**' in any of their varied meanings. The clear meaning of '**by**' in the definition is: 'indicating agency, means, cause, attendant circumstance, conditions, manner, effects'[109] ".[110]

Bosch on the other hand is of the view that an assumption could be made that the legislature did not apply its mind to the matter because there is no indication that the debates prior to the introduction of the amendments dealt with the application of section 197 to second-generation outsourcing.[111]

Bosch indicates that it is trite that the fact that legislation is going to cause difficulty and reluctant compliance has never prevented the legislature from passing such legislation. Legislation is often introduced to compel parties to do what they would otherwise choose not to do. The fact that requiring an

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105 Bosch 2007 *Obiter* 88.
106 Van Niekerk *et al* 311.
107 Wallis 2006 *ILJ* 10.
108 Wallis 2006 *ILJ* 11.
109 *The Shorter Oxford Dictionary* 5ed (2002) Vol 1 317 meaning 5.
110 Wallis 2006 *ILJ* 12 and 13.
111 Bosch 2007 *Obiter* 89.

agreement from the outgoing contractor might be awkward or meet with resistance cannot be taken as a sign that the legislature did not intend it.[112]

There is a difficulty with suggesting that to give the section its plain meaning, gives rise to an anomaly. Wallis indicates that it does nothing of the sort unless one assumes that first-generation outsourcing is within the section and equates it with second-generation outsourcing, and this should not be done because the first assumption is not necessarily correct and secondly the two are not the same thing.[113]

### *3 3 4 Practical implications*

If section 197 were to apply to second-generation outsourcing, various practical implications could arise because the incoming contractor would have to take on the employees of the outgoing contractor on their existing terms and conditions.[114]

Grogan points out that such an interpretation does not help service providers who make their living out of outsourcing arrangements. Entities tendering for such contracts obviously have to seek to undercut the current contractor, and it may be difficult to do so if they are required by law to take over the current contractor's staff on the same or at least similar conditions of service.[115]

Bosch uses the following example: a person tendering for a contract will find it difficult to determine the appropriate amount to quote for providing its services. Information regarding the existing terms and conditions and other necessary information, may not be generally available and it is unlikely that the outgoing contractor, who may be competing for the contract, will be happy to provide this information to its competitors.[116]

Would this not lead to an undercutting of wages in the industries involved as the clients turned to outsourcing as a means to reduce costs and could thus merely grant the contract to the most cost-effective tenderer?[117]

Bosch says that it is conceivable that prospective contractors will tender on the basis of reduced labour costs and the terms and conditions of employees doing the same jobs at the same place year after year will be systematically whittled down with each successive service contract. But Bosch suggests that the South African government should be concerned at the prospect of contractors being able to compete by cutting labour costs as opposed to cutting other costs or improving efficiency.[118]

The CC in *NEHAWU v University of Cape Town*[119] reiterated that section 197 was intended to give blanket protection to employees whose employers

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[112] *Ibid*.
[113] Wallis 2006 *ILJ* 15.
[114] Bosch 2007 *Obiter* 90.
[115] Grogan and Gauntlett October 2005 *EL* 13.
[116] Bosch 2007 *Obiter* 90.
[117] *Ibid*.
[118] Bosch 2007 *Obiter* 92.
[119] 2003 3 SA 1 (CC).

transfer a whole or part of their businesses as going concerns.[120] Section 197 protects workers in that the transfer of a business may not be used as a basis to retrench workers or reduce their terms and conditions.[121] Would the employees subjected to second-generation outsourcing scenarios receive this protection if their terms and conditions were whittled down by successive service contracts?[122]

Van Niekerk *et al* submit that when the literal wording of the section is applied, the result is that employees involved in the second transfer have less protection than those involved in the first transfer. This also has commercial ramifications, as the replacement or second contractor bidding for the new contract is in a much better position than the potentially outgoing contractor – the bidder is not bound by section 197 transfer provisions and so can save employment-related costs that the first contractor could not avoid. The first contractor will also be liable for severance pay and statutory notice payments. All in all, it seems to be an unsatisfactory result for the employees as well as the outgoing contractor.[123]

Other implications that have not been considered by the courts mentioned in this discussion above, include:

- A contractual relationship with the outgoing contractor is often terminated by the principal after due consideration of performance and thus with improvement (or lack thereof) in efficiencies and/or productivity in mind. If section 197 were to apply to second-generation outsourcing, the employees of the outgoing contractor would automatically transfer to the incoming contractor who has been awarded the tender by the principal. The employees of the outgoing contractor could well be the very cause of the reduced efficiency and/or productivity (that is, unsatisfactory performance). If these employees are thus automatically transferred to the incoming contractor, so too do the possible causes of the unsatisfactory performance.
- Most employers in South Africa's commercial environment are subject to vast socio-economic responsibilities in terms of employment legislation such as affirmative action in terms of the Employment Equity Act,[124] development of suitably qualified employees from the designated groups in terms of the Skills Development Act,[125] and the scorecard requirements in favour of the previously disadvantaged groups in terms of the Broad-Based Black Economic Empowerment Act[126]. Most employers have thus developed policies with regard to these socio-economic responsibilities. However, if section 197 were to apply to second-generation outsourcing, these policies of the incoming contractor would be circumvented if the incoming contractor automatically inherited the

[120] Grogan April 2005 *EL* 4.
[121] Bosch 2007 *Obiter* 96.
[122] *Ibid*.
[123] Van Niekerk *et al* 311.
[124] 55 of 1998.
[125] 97 of 1998.
[126] 53 of 2003.

employees from the outgoing contractor. So too would the internal recruitment and selection policies of the incoming contractor.

### *3 3 5 In the wake of Zikhethele*

The LC in *Zikhekthele* preferred to follow the purposive approach to the question whether or not section 197 applied to a situation involving second-(or subsequent) generation outsourcing.[127]

The question to be asked is whether all outsourcing arrangements will attract the provisions of section 197, or will only some of them?

*Zikhethele* may have far-reaching consequences for employers conducting business in the service industry. If it can be said that the business initially outsourced from A to B will retain its identity after the transfer to C, section 197 is likely to apply, which means that C will be obliged to take over the employees on the same terms and conditions of employment.[128]

The LC *Aviation Union of South Africa V SAA (Pty) Ltd*[129] limited the reach of section 197 so as not to ensnare second-generation outsourcing.

The LC stated that it preferred a purposive interpretation of section 197, but ultimately the court held that the wording of section 197 was not ambiguous nor unclear and therefore regard must be had to the plain wording of the provision (in other words section 197(1)(b)).

> "Although I am in agreement with the sentiment expressed that section 197 should be read so as to protect the work security of employees affected by a business transfer, I am of the view that it is clear from section 197 of the LRA that the legislature had only contemplated a transfer *from* the old employer to the new employer and nothing else (the so-called first generation transfer). The intention of the legislature appears to me to be readily apparent from the clear wording of section 197(1)(b). Consequently, I am of the view that there does not appear any necessity to read into section 197 words that are not there."[130]

The LC rejected the finding in *Zikhethele* and stated that *Zikhethele* is authority for the proposition that where the second business is so closely aligned to the first business that it is in fact identical, section 197 may be applicable in a second-generation outsourcing.[131]

The LC concluded that section 197 only contemplates first-generation outsourcing; in other words, the situation where the business is transferred by the old employer to the new employer and not second-generation outsourcing.[132]

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127 Van Niekerk *et al* 311.

128 Laubscher December 2005 *De Rebus* 49.

129 [2008] 1 BLLR 20 (LC).

130 *Aviation Union of South Africa v SAA (Pty) Ltd supra* par 24.

131 *Ibid.*

132 Cheadle, Le Roux, Thompson and Van Niekerk *Current Labour Law Review: The Authoritative Review of Labour Law for 2008* (2008) 57.

In *Crossroads Distribution (Pty) Ltd t/a Jowells Transport v Clover SA (Pty) Ltd*,[133] the LC raised three issues:

- Is a transfer of service covered by section 197?
- Does section 197 cover second-generation outsourcing contracts?
- In the circumstances of this case, was there the transfer of a business for section 197 purposes?

The LC's answers to these questions were "yes", "no", and "no" respectively.[134]

Revelas J stated:

> "An entity which provides … services is indeed capable of being transferred within the meaning of section 197(1)(b). However, the same reasoning does not apply to the contract which governs the terms and conditions upon which such services are rendered. That is not capable of being transferred, in my view."[135]

The LC considered the following example when making its decision: a municipality has a contract with a certain car hire company (company A) to meet the travel needs of its employees. If it then terminates that contract and concludes a contract with company B, must all the employees of company A now be employed by company B? "Surely not", was the court's response.[136]

In arriving at its findings, the LC adopted the reasoning of Basson J in the *Aviation Union of South Africa v SAA (Pty) Ltd* LC case, but rejected that of Murphy AJ in the *Zikhethele* case. While it may be so that workers affected by a second-generation outsourcing may be in the need of protection, that was something that should be left to the legislature.[137]

## 4 HAS CLARIFICATION FINALLY BEEN PROVIDED?

In LAC matter of *Aviation Union of South Africa v SAA (Pty) Ltd,*[138] Davis JA held:

> "Sophistry aside, there is no compelling reason to conclude, on the wording of section 197(1)(b), that the new employer (i.e. the initial transferee) has not transferred the business to a third party or to the initial transferor. In other words the initial transferee became the employer after the initial transfer. Pursuant to the contract which caused the initial transfer, the existing employer is now obliged to transfer the business to a party which will now become the new employer. Hence the second generation transfer falls within the scope of the definition."[139]

Zondo, JP opined:

> "It is difficult for me to see what purpose sec 197 can be said to aim to achieve if the protection which it gives to workers against job losses is limited

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133 [2008] 6 BLLR 565 (LC).
134 Cheadle *et al* 53.
135 *Crossroads Distribution (Pty) Ltd t/a Jowells Transport v Clover SA (Pty) Ltd supra* 568.
136 Cheadle *et al* 55.
137 [2008] 6 BLLR 565 (LC) 569.
138 (Not yet reported) 2009-10-09 Case number JA 51/07.
139 *Supra* par [60].

> as it has to be conceded would be the case if the word "**by**" in the section was read to mean what it normally means. In such a case the protection of workers would be limited to the first outsourcing and nothing more … The situations in which the workers need protection the most is where they are dealing with the employers who are trying to get rid of them. That is where sec 197 counts. However, that is where it would not apply if the school of thought that propounds a Literal meaning were to prevail."[140]

Zondo, JP is of the view that a literal meaning of section 197 would render section 197 "for all practical purposes worthless" as any employer who wishes to transfer his business without the workers as a going concern could do so by initially dumping the workers with another party (first-generation outsourcing) and thereafter transfer his business as a going concern to someone else (second-generation outsourcing) without the workers.[141]

In coming to its conclusions, the LAC considered the following example (which is similar to the facts of *SAA*): Company A wishes to rid itself of a group of employees who form a discrete business unit within A. It enters into an agreement with Company B whereby the particular business unit which forms part of A's overall business is transferred as a going concern to B. In short, B will now ensure performance of the operations of that unit. This transaction between A and B can be classified as an outsourcing agreement. The agreement includes the right of A to cancel the outsourcing agreement within a year which would thereby obligate B to transfer the business back to A. If the literal interpretation is adopted, the entire protection of section 197 afforded to employees in the unit could be circumvented in that, once the business is retransferred to A, the latter would have no obligations to any of the employees pursuant to section 197 of the LRA. Davis JA held that "this result would surely be subversive of the very purpose of section 197 and can only be sustained if the wording of the section could plausibly bear no other interpretation".[142]

Is this example cited by the LAC, not an example of third-generation outsourcing as referred to by Wallis?[143] (That is, third-generation outsourcing is the decision by a principal to terminate a contract for the provision of work or services and to use its own employees or employ people itself to undertake the work.)[144]

Has the LAC provided clarity with regard to the application of section 197 to second-generation outsourcing? It appears as if the LAC has broadened the scope of the application of section 197 to third-generation outsourcing by considering only the implications of its non-application to these third-generation arrangements. However, the LAC attempts to provide clarity on the application of section 197 to second-generation outsourcing but it did so without taking the cumbersome implications of its application[145] to second-generation transfers into consideration.

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[140] *Supra* par [30].
[141] *Supra* par [29].
[142] *Supra* par [58].
[143] See par 3 2 above.
[144] Wallis 2006 *ILJ* 4.
[145] See par 3 3 4 above.

## 5 CONCLUSION

The courts have been consistent regarding the approach to be adopted in determining whether there has been a "transfer" as a "going concern" in its simplest form. The courts are to follow the test for the transfer as a going concern formulated by the CC in *NEHAWU v University of Cape Town.*[146] The test requires an examination of all the components of a business to determine whether the "business" has transferred for the purposes of section 197. No single factor is determinative.[147] The courts will need to determine on the facts of each case whether there has been a transfer as a "going concern" in terms of section 197.

The article sets out the confusion created by the courts with regard to the interpretation and application of section 197 in an outsourcing (whether first- or second-generation) context. The LAC in *Aviation Union of South Africa v SAA (Pty) Ltd,*[148] was the most recent of the myriad of judgments, however, the LAC did not shed any clarity on the ongoing debate.

Wallis is of the view that, considering the purpose of section 197 which is to balance and protect the interests of both the employee and the employer, it is an acceptable theory that the legislature deliberately decided to limit the scope of section 197. It can be limited to those transactions where two parties decide to bring about a change in ownership of a business by whatever means, but not to extend the section to more remote situations as has occurred elsewhere.[149]

Bosch advocates that

> "in interpreting and applying section 197, the courts should not lose sight of the purpose of the section in securing the employment and rights of employees in times of business transfer and this entails that the scope of application of the section should not be narrowly tailored … The courts are going to have to decide in which situations the protections conferred by section 197 should properly be extended to employees. Employees are vulnerable during the processes of business restructuring and the proper protection of employee rights may require the courts to construe section 197 more widely than narrowly … It is imperative that the courts develop a clear and coherent jurisprudence around when section 197 applies and what its effects will be … the section has far reaching consequences and it is thus crucial for employers and employees to have clear guidance as to when those consequences need to be considered".[150]

It is submitted that detailed consideration should be given by the courts to both the rights of employees as well as the responsibilities of the employers as parties to the employment arena. On the one hand, the view that section 197 should apply to second-generation outsourcing brings the benefits for the employee to the forefront. However, this interpretation ignores the pitfalls for the employer. On the other hand, the interpretation that section 197 should apply to first-generation outsourcing alone, disregards the protection

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146 2003 3 SA 1 (CC).
147 Bosch 2007 *Obiter* 94.
148 (Not yet reported) 2009-10-09 Case number JA 51/07.
149 Wallis 2006 *ILJ* 13.
150 Bosch 2004 *ILJ* 1882.

of employees (which is paramount to fair labour practices), yet considers the benefits for the employer in a cruel and competitive economy.

Bosch sums up the scenario best:

> "If the provisions of section 197 are properly utilised it should not have the effect of hamstringing employers or inhibiting business transfers, as it contains a number of mechanisms that enable parties to ensure that it operates in a manner that is in the best interest of employers and employees."[151]

Since the amendment of section 197 in 2002, this is yet to be seen. The question no longer remains: does section 197 apply to second-generation outsourcing? The question should now be whether section 197 should apply to outsourcing (so-called first- or second- or third-generation outsourcing) at all.

[151] *Ibid*.