



Confronting Employment Issues in China M&A Deals

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Employment-related issues are some of the most important issues that buyers are confronted with in M&A deals all over the world, including China. A carefully managed strategy towards employment-related issues can avoid the pitfalls that history has shown to derail potential China M&A deals. A recent example of the significant impact that employment issues could have on a potential transaction is Apollo Tyres' failed acquisition of Cooper Tire in 2013, where the parties eventually terminated the deal and sued each other because of a seven month employee strike and persistent workplace unrest in Cooper Tire's Chinese manufacturing plant.

The following is a review of the typical employment issues arising in China M&A deals and practical suggestions for buyers when confronting these issues.

I. DEAL STRUCTURE AND ITS IMPACT ON EMPLOYMENT ISSUES

The choice between acquiring the assets or equity of a target has a significant impact on employment matters in China, where at-will employment arrangements do not exist.

Asset Deal

In an asset acquisition where specified assets and liabilities are acquired and assumed by a buyer, the employees of the target and the related employment contracts are not automatically transferred to the buyer under PRC employment law. In order to transfer the employment arrangements to the buyer, the target and the employees must first agree to terminate the existing employment contracts and the amount of severance to be paid by the employer.¹ After such termination, the employees and the buyer must then enter into new employment contracts.

Statutory severance calculations may be different from the practices that a western buyer typically confronts. The employer is required to pay statutory severance calculated at the rate of one month's average salary for each year of service. The "average salary" is the employee's average salary during the 12 months immediately prior to the termination and is capped at an amount equal to three times the local city's average salary during the last calendar year.² If a buyer recognizes the employees' tenure with the target when hiring them, the target will not have severance obligations and instead, the buyer will assume the obligation to pay severance for the employees' tenure if the buyer later terminates the employees without cause. The recognition of tenure may also affect the employees' benefits such as annual leave entitlement under the buyer's employment policies.

Although individual severance amounts in China are not significant compared to western standards, severance negotiation in China provides the employees with leverage against the target and indirectly, with the buyer. Employees typically ask the target for higher severance than what is statutorily required and when an employer rejects such request, some employees resort to strikes, protests and sometimes, violence.

The risk of unrest and uncertainty by severance negotiation is a persuasive reason for buyers to recognize the tenure of the employees to be transferred, which is what occurs in a majority of China asset



acquisition deals. Recognizing the employees' tenure reduces immediate transaction costs for the buyer and avoids the loss of employees who could be critical to the target's ongoing operations.

Although the approach of terminating employment contracts with the target and entering into new employment contracts with the buyer has a number of inherent risks, it could also result in a clean separation between the target and the buyer with respect to employment liabilities. When taking this approach, the buyer does not assume pre-closing liabilities that may arise as a result of the target's non-compliance with PRC employment law. This also allows a buyer to pick-and-choose the target's employees by selectively entering into new employment contracts only with certain employees who the buyer wishes to retain. Another potential advantage for the buyer is that it can (and often does) negotiate new terms and conditions under new employment contracts with the transferred employees that may have terms more favorable to the buyer.

Equity Deal

In contrast to an asset deal, the "employer" in an equity sale does not change when the target's equity is transferred from one group of shareholders to another group of shareholders. Therefore, the existing employment contracts between the target and its employees and the employees' tenure survive the transaction and no direct employee transfer is made. Although the employees have the right to resign from the target after an acquisition is completed, the target is not required by law to pay severance in the case of resignation. Golden or tin parachutes, under which an employee has the right to leave the employer with severance if the employer undergoes a change in control, are rare in China. Therefore, an equity deal allows the buyer to retain the target's employees without significant additional costs.

However, the disadvantage of an equity transaction is that the buyer will assume employment law liabilities that the target incurred before the closing such as underpayment of social insurance contribution or the failure to have written employment contracts. An equity deal also means that the buyer will retain all of the existing employees, including under-performing and potentially redundant employees. The buyer may face difficulties in terminating those under-performing and potentially redundant employees after the completion of the acquisition because as already discussed, China is not an at-will employment jurisdiction. Underperformance and redundancy are permitted causes for termination, but are subject to procedural requirements and strict scrutiny review by the labor arbitration commissions and local courts. In reality, it is fairly difficult for employers to terminate employees for underperformance or redundancy due to the employer's lack of evidence to support underperformance or redundancy, or a failure to meet the procedural requirements.

There are instances in which employees of the target ask the target to pay severance to "buy out" their tenure with the target prior to the consummation of an acquisition even if the target does not have a legal obligation to do so. For instance, a multinational corporation sold its ownership interest in its China business in November 2011. The employees of the China business went on strike against the proposed transaction. One of the employees' requests was for the multinational corporation to pay severance in accordance with the employees' tenure before the transaction is consummated. The strike finally ended after the multinational corporation and the buyer made several significant concessions to the employees, including a guarantee of no lay-offs within two years after the closing and severance payments to employees who chose to leave the China business.

II. COMMON EMPLOYMENT ISSUES IN M&A DEALS IN CHINA

Underpayment of Social Insurance and Housing Fund Contributions

All employers and employees in China are required to contribute funds to the social insurance programs of pension, medical, unemployment, work compensation, and maternity benefits insurance. Despite such requirements, many companies fail to pay, or underpay, the social insurance and public housing fund contributions due to the high costs. Although the contribution rate varies from city to city and is calculated based on an employee's salary, the employer portion of the contributions for social insurance programs and public housing fund can be as high as 44% of the employee's salary, which is a significant additional cost to the employer. This issue is exacerbated by rapidly rising labor costs in China, where average wages increased by 10.7% in 2013 and is expected to increase by 10–15% in 2014.



Nonpayment or underpayment of social insurance and public housing fund contributions not only exposes the target to penalties imposed by the labor authorities and civil claims by the employees, but may also become a fuse to workplace unrest. For example, a strike took place in Dongguan City, Guangdong Province in April 2014 after workers discovered that their employer had underpaid social insurance contributions. More than 10,000 workers at the Yue Yuen Shoe Factory went on strike, demanding full payment of social insurance contributions, as well as salary increases and renegotiation of labor contracts. The local labor authorities and trade union intervened and the strike ended only after Yue Yuen agreed to pay the overdue contributions and increase the employees' compensation and benefits. The strike and the related settlement reportedly cost Yue Yuen up to US\$27 million.

Failure to Sign Written Employment Contracts

An employer is required to sign employment contracts with all of its employees in China. The failure to sign employment contracts may subject the employer to civil claims by the employees, with damages that could be one month's salary for each month that passes without a written employment contract, capped at 11 months' worth of salary.

Despite the risk of civil claims from employees, many companies in China, particularly those owned by local Chinese entrepreneurs, typically do not have good internal controls to track whether employment contracts have been signed or timely renewed. As a result, a common due diligence issue that arises in many deals is the target's failure to have valid employment contracts with some or all of the employees, and the resulting exposure to civil claims from the employees.

Failure to Pay Overtime

An employer's failure to properly pay for overtime work is another common issue that arises in due diligence. There are three working hour systems in China: standard working hour system; comprehensive working hour system; and flexible working hour system. Employees who work under the *standard working hour system* and the *comprehensive working hour system* are similar to non-exempt employees in the United States and are entitled to overtime pay. The rate of overtime pay is approximately 150% of the regular salary for workday overtime, 200% of the regular salary for weekend overtime and 300% of the regular salary for public holiday overtime. In contrast, employees who work under the *flexible working hour system* are similar to exempt employees in the United States and are generally not entitled to overtime pay.

We often come across targets that do not properly pay or underpay overtime to employees. When a buyer acquires a target through an equity transfer, the liabilities for past due overtime pay transfer to the buyer and the target's employees may claim accumulated overtime pay for many years before the closing.

Lack of Sufficient Protection of Intellectual Property Rights

Many companies in China fail to enter into appropriate agreements with their employees for the protection of intellectual property rights and trade secrets. Only a minority of companies enter into non-competition agreements with senior managers and research and development personnel. If a buyer places a high value on the target's employees and intellectual properties, the buyer would need to carefully review the target's IPR protection and non-competition agreements to assess the risk of such value walking out the door as soon as the closing is completed.

RECOMMENDATIONS

In order to address potential employment issues in China M&A deals, the deal team should involve experienced employment lawyers at an early stage of due diligence to conduct a thorough labor and employment due diligence investigation on the target. Once all of the potential issues are identified, the deal team can work with the employment lawyers to propose remedial measures to address those issues.

Adding contractual protections in the transaction agreements is another effective way to contain the employment law risk exposure. Typical contractual protections include representations and warranties made by the target and the sellers and indemnification protection for the benefit of the buyer for



compliance with laws and losses arising from non-compliance with such laws. The buyer may also consider installment payments or use a purchase price holdback to protect against potential losses arising from employment law issues.

Most importantly, the buyer should work with the target and the seller(s) to prepare a detailed plan to address potential workplace unrest such as protests, strikes and even violence against local managers. History has shown that employees can go on strike to protest a proposed deal in order to extract benefits out of the change in employer relationships and resort to violence if they believe that their jobs will be made redundant by the proposed deal. We have seen highly volatile reactions from employees towards pending acquisitions, but we have also seen buyers, targets and sellers adeptly handle the reaction because a plan was devised very early in the deal process to address such a contingency.

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¹ The concept of at-will employment does not exist in China. Employers are required to sign multi-year employment contracts with every employee and the employer can only unilaterally terminate an employment contract under specific and limited circumstances prescribed under Chinese employment law. Severance is typically required even if the employer and the employee mutually agree to terminate an employment contract, unless the new employer (the buyer) agrees to recognize the employees' existing tenure with the target.

² The average salary in Shanghai in 2013 was RMB5,036 (US\$812) per month and the average salary in Beijing in 2013 was RMB5,793 (US\$934) per month.