

Resolving Human Capital Issues in M&A Transactions

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Human Capital: One of the Fundamental Factors to Consider in M&A Structure

- ◆ Assess, Address and Avoid Work-Force-Related Liability
- ◆ Efficiency-Driven Downsizing
- ◆ Talent-Retention to Ensure Smooth Transition
- ◆ Political and Publicity Concerns

Understanding Structure, Unique Features and Application of China's Labor and Employment Law

- ◆ **Applicable national, provincial and local laws and rules**
 - **National law: adopted by National Congress and its Standing Committee: e.g., Labor Law of 1994**
 - **Administrative regulations and provisions promulgated by State Council: e.g., Provisions on Working Hours of 1995**
 - **Implementing Administrative Rules issued by various ministries e.g., opinion on Certain Issues in Implementing Labor Law**
 - **Local legislations adopted by provincial/municipal legislatures: e.g., Shanghai Labor Administration Regulations**
 - **Local rules and “documents” issued by provincial/municipal departments and legislatures of provincial capital and “specially authorized “large cities: e.g., Nanjing and Ningbo**
 - **Hierarchical priority under China's Legislation Law**

China's Employment Law (continued-1)

- ◆ “Quasi-binding” administrative “circular” or “guidelines”
 - Legislative authority
 - Intent and purpose of the government authority
 - Compliance with procedural requirements for legislation
 - Consistency with superior regulations and rules
 - “Exclusiveness” of application under local court rules
 - “Administrative coordination” in dispute settlement and leverage gained

China's Employment Law (continued-2)

- ◆ No “at-will” employment
 - Every employment contract must have a term
 - No termination without cause is permitted
 - “Causes” defined:
 - continuous job performance failure after adjustment of duties or training
 - long term illness or non-job related disability after medical treatment
 - violation of company’s labor rules
 - criminal indictment
 - fundamental changes of circumstance, the non-occurrence of which is a condition when the parties enter into contract
 - bankruptcy or “extreme difficulties in production and operation”
 - Exception: contract to be carried over in M&A of affiliated companies

China's Employment Law (continued-3)

- ◆ Years of “continuous service”(“YCS”)
 - Basis in calculating “economic compensation”: one month compensations for each YCS
 - Permitted carry-over of “YCS” accrued at former JV partner
 - Employees with over 10 YCS is eligible for contract with “indefinite term”

China's Employment Law (continued-4)

- ◆ Wage, hours and labor conditions rules
 - General requirement: 8 hour per day; 40 hours per week
 - Premium is required for overtime
 - “Unit-based” wage system is not permitted unless
 - “abundant supply” of work
 - No decrease of compensation otherwise due under “hour-based” system
 - Social benefits: pension, unemployment, medical, disability and housing
 - Safe and hygienic working condition

China's Employment Law (continued-5)

◆ Labor union

- Centralized and top-to-bottom dictated structure of All China Federation of Labor Union under CCP
- Recent campaign for unionization and political motivation
- Union-related requirements
 - union's right to participate employment related board discussion
 - union's right of being consulted in termination
 - full or part-time position with pay for union leader

China's Employment Law (continued-6)

- ◆ Debate surrounding China's drafting its new Labor Contract Law
 - CCP's goal of "building a harmonious society" and undercurrent policy shift
 - Recent heated debates over new draft of Labor Contract Law
 - Example: union's consent is required for large scale downsizing
 - Example: employee's seniority instead of job performance determines sequence of termination

Restructure Labor Force in M&A

- ◆ Conduct a labor due diligence before doing business with a company
 - Documents to be reviewed and analyzed
 - Passage of “annual auditing” may not be a conclusive evidence
 - Diligence focus should go further beyond mere approval and registration documents

Restructure Labor Force in M&A (continued-1)

- ◆ Leverage your position and ally with local government
 - M&A often requires multi-departmental coordination
 - Identify who is in charge and a better position for daily coordination
 - Leverage your image, benefit to local community and investment commitment for assistance and maximum benefits

Restructure Labor Force in M&A (continued-2)

- ◆ Negotiate with target company/seller for accounting and sharing the costs
 - Rationale suggests the costs pertaining to YCS to be shared with seller
 - Scenario one: equity transfer
- Scenario two: Chinese JV partner buy-out

$$\text{Reserve} = \text{total compensation} \times \frac{\text{YCS for Seller}}{\text{total YCS}}$$

$$\text{Deduction} = \text{total compensation} \times \left(\frac{\text{YCS for Partner}}{\text{total YCS}} + \frac{\text{YCS for JV}}{\text{total YCS}} \times \text{Chinese partner equity \%} \right)$$

Restructure Labor Force in M&A (continued-3)

- ◆ Ensure compliance with substantive requirements
 - Substantive requirement one: extreme production and operation difficulties
 - Audited balance sheet and financial statements
 - Inability vs. failure to pay wages for past months
 - Mismanagement or breach of fiduciary duty another cause of action
 - Paying up required compensation package

Restructure Labor Force in M&A (continued-4)

- ◆ Follow the procedural requirements step-by-step
 - Explain to the trade union or all the employees with necessary proof
 - Propose a labor reduction plan
 - Solicit opinions from the trade union or all employees on reduction plan
 - Submit plan to local labor administration and union or employees for comments
 - Officially announce the reduction plan, terminate and pay compensations

Restructure Labor Force in M&A (continued-5)

- ◆ Minimize the negative impact of required participation of labor union
 - Limit union's participation to board meeting to the minimum and avoid sensitive topics before its representative
 - Require a confidentiality commitment before board decision
 - Take labor restructure as an opportunity to minimize union impact

Restructure Labor Force in M&A (continued-6)

- ◆ Develop a mechanism to eliminate/reduce labor-related exposures
 - Obtain some verbal or written comfort from labor administration and employees
 - Make labor restructure a condition precedent to closing
 - Retention of a contingent amount of purchase price
- ◆ Avoid media and reduce “public light”

THANK YOU!

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